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PRESIDENT'S COMMISSION
FOR A NATIONAL AGENDA FOR THE EIGHTIES

REPORT OF THE PANEL ON
GOVERNMENT AND THE REGULATION OF
CORPORATE AND INDIVIDUAL DECISIONS

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I

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Washington : 1980

II

This document was prepared by the Panel on the Government and the Regulation of Corporate and Individual Decisions, one of nine Panels of the President's Commission for a National Agenda for the Eighties. The report represents the views of a majority of members of the Panel on each point considered. Not every member of the Panel agrees with or supports every view or recommendation in the report. This report was prepared by members of the Panel without involvement by members of the Commission who were not members of the Panel. This project was supported by the U.S. Department of Commerce, under provisions of Executive Order No. 12168, October 24, 1979. Points of view or opinions expressed in this volume are those of the Panel on Government and the Regulation of Corporate and Individual Decisions, and do not necessarily represent the official position of the U.S. Department of Commerce.

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Foreword

As America enters the eighties, our nation faces a world greatly changed from that of even a decade ago. Vast forces are in action at home and abroad that promise to change the lives of all Americans. Some of these forces—such as revolutionary developments in science and technology—hold out hope for longer life, labor-saving mechanisms, exploration of the universe, and other benefits for all peoples. Other forces—such as the growing demand for strategic raw materials under the control of supplier cartels—raise serious problems for all nations. At home, we face serious and unresolved issues in the social and economic structure of American society.

On October 24, 1979, President Jimmy Carter established the President's Commission for a National Agenda for the Eighties. His purpose was to provide the President-elect and the new Congress with the views of 45 Americans drawn from diverse backgrounds outside of government. The group is bipartisan, representing business and labor, science and the humanities, arts and communication. Members of the Commission are experts in many fields, but possess no special expertise in predicting the future. Rather, we have done our best to uncover the dynamics of American society and world affairs that we believe will determine events in the eighties. This report of the Commission, *A National Agenda for the Eighties,* sets forth our views.

The analytical work of the Commission was accomplished by 9 Panels, each consisting of 5 to 11 Commissioners with appropriate staff. The Panels probed into major subject areas designated by the President in the Executive Order that created the Commission, as well as other areas that the Commission itself determined should be on the agenda. This approach gave Panel members an opportunity to gain considerable familiarity with complex subject matters, and provided the full Commission with a wide range of information not otherwise attainable in the 13 months available for this study.

The Panels are responsible for their own reports, and the views contained in any Panel report do not necessarily reflect the views of any branch of government or of the Commission as a whole.

William J. McGill
Chairman

La Jolla, California
December 31, 1980

Preface

The Panel on Government and the Regulation of Corporate and Individual Decisions consisted of half a dozen persons with highly diverse perspectives. We knew, as we commenced our work in the spring of 1980, that we had only a few months, and limited resources, with which to do our job: the writing of a useful and relatively brief statement on regulation in the 1980s. Thus, as became immediately clear to us, we could not possibly agree on a detailed prescription for each of the nation's many regulatory problems. We decided, instead, to work out a general framework within which government regulation might profitably be assessed and to discuss selected regulatory issues within that framework.

The result, although informed by considerable research, is not primarily a work of scholarship. Rather, the report is the product of the collective efforts of all Panel members, who drew upon their experiences with different regulatory fields. Clearly, the contributions of every member have sharpened the analysis in the report, and we wish to thank our colleagues for their efforts. More importantly, however, the Panel's process illustrates the central proposition of the report—that patient and careful analysis of regulatory issues can produce a high degree of consensus with far less conflict than now characterizes the regulatory process.

The final Panel report also owes much to the thoughtful comments from the public on earlier drafts and to the work of the professional staff of the Commission. The Panel met several times throughout 1980 in sessions open to the public. Successive drafts of our report were circulated among a large and diverse audience—government regulators, interest groups, academics, Congressional staff, and others. The Panel received many useful suggestions (and was spared innumerable errors) by the care with which these drafts were examined. We cannot, in the space available, name all those who have left their mark on these pages. The following, however, deserve special recognition: Robert Eisenbeis at the Federal Reserve Board, David Beam with the Advisory Commission on Intergovernmental

Relations, Stephen Stich from the University of Maryland, and Frank Cummings and Lena Zezulin of the law firm of Marshall, Bratter, Greene, Allison & Tucker. Moreover, we are grateful to the Department of Commerce for financing the work of this Panel. In addition, we wish to acknowledge the professional staff assigned to our Panel, William Jordan and Christopher Foreman, whose assistance in writing the report was consistently excellent. Finally, we wish to thank Commission Chairman William McGill, Staff Directors Claude Barfield and Richard Wegman, Staff Secretary Vondell Henson, and the rest of the Commission staff.

Three disclaimers are in order. First, although the Panel acknowledges its debt to the Department of Commerce and a variety of outside sources, they are in no way responsible for any errors of fact or interpretation that may have crept into the report, nor do they necessarily share the views expressed in this report. The Panel alone is accountable. Second, although all members of the Commission were given an opportunity to comment on an earlier draft of this report, they are not responsible for its contents. Third, while the Panel operated consensually (rather than by vote), not every member of the Panel necessarily agrees with every point in this report. Nevertheless, we all believe that this report can help to improve the efficiency and fairness of government regulation.

Alan B. Morrison

Alan B. Morrison
Panel Co-Chairperson

Roger G. Noll

Roger G. Noll
Panel Co-Chairperson

Washington, D.C.
December 31, 1980

GOVERNMENT AND THE

Regulation

OF CORPORATE
AND INDIVIDUAL DECISIONS

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Chapter 1

Introduction

Government regulation is likely to continue to receive major attention in the 1980s, just as it has in every decade since the 1930s. Regulation continues to be a public issue because it is inherently controversial. Usually it attempts to prevent, or make more costly, some behavior that people value. In accommodating one demand, it imposes a new cost on someone else. Moreover, the industries and activities that regulation is designed to control change over time because of changes in tastes, technology, and income distribution. Thus, the rationale for an agency, and its list of detractors and defenders, can also be expected to change. It is no surprise, then, that regulatory policy issues—unlike issues in most other areas—never seem to be won or lost, but to persist, often in different forms, through the decades.

Although there are many points of debate over regulation, there is a consensus on the need for regulation in some areas. For example, national polls show that Americans, while desirous of a reduction in regulation overall, want more stringent controls to protect their health and the environment. At the same time, polls also show that Americans believe there is too much regulation. For the most part, the general perception of regulation tends to be largely anecdotal and incomplete; it focuses on isolated but well-publicized "horror stories." Colorful examples of arbitrary, incomprehensible, or outrageously petty behavior by either regulators or business can be useful in generating political action. However, to focus exclusively on such items is to overlook the major questions that need to be voiced about regulation.

In recent years, there has been a great deal of very useful scholarly writing devoted to generic issues of government regulation. While this literature is useful, as with popular public perceptions, much of it overlooks important aspects of regulation and its effects on society. Without attempting to survey this literature systematically, it is helpful to review some of the more important recent contributions.

One group of writings is devoted to estimating and publicizing the cost of regulation. This literature convincingly makes the point that regulation is a very important public activity, comparable in its economic impact to national defense spending, income maintenance programs, or health care costs. Some authors contend that these figures support the conclusion that the country has become overloaded with costly regulations. They argue that even if every regulatory program were useful, there are still too many to allow effective administration without conflict, skyrocketing costs, or unacceptably diminished liberty.

Many reject this view, arguing that the overall regulatory burden can be reduced by improving the efficiency of individual programs. While awareness of the costs of regulation is important, it should be the beginning, not the end, of analysis. Regulation is not one gigantic decision, but the cumulation of many little ones. Thus, knowledge of its total cost does not provide direction as to where (or even whether) to look for cost reductions. Moreover, information on costs—whether for all regulation or for a particular program—is an insufficient basis for deciding whether there is too much, too little, or just the right amount of regulation. That requires assessing benefits as well as costs, and determining whether some other policy could provide a more attractive combination of the two. Many of the benefits are extremely difficult to measure: how many lives will be saved by eliminating carcinogens from the workplace and how to assign a dollar value to them. Other benefits, such as smog-free air in Los Angeles, the preservation of an endangered species, or the joy of exploring a wilderness area, are difficult to evaluate in monetary terms. Moreover, this analytical approach can only be applied at the level of specific regulatory policies; regulation is simply too heterogeneous to be comprehensively evaluated at a high level of generality.

A second body of literature addresses some characteristic problems that seem endemic to regulation as an instrument of public policy. Critical reviews of particular regulatory policies have certain common themes: regulatory processes take too long, are too costly for participants, retard innovation, have anti-competitive effects on regulated industries, reach inconsistent outcomes in apparently similar situations, inhibit rational long-term planning by business because of their unpredictability, and produce policies that are too inflexible and too difficult to change.

While all of these criticisms are valid in certain areas of regulatory policy, the conclusions to be derived from them are not obvious. The reason is that regulation often has these effects as a necessary byproduct of the procedural requirements imposed on it. The regulatory process is not intended to generate decisions singlemindedly,

nor to achieve stability, consistency, and predictability at all costs. Rather, its procedures are designed to assure that anyone with a stake in a decision will have an opportunity to be heard and that, in each case, the decision of the regulator will be based on the information presented. In short, regulation is designed to establish a balance among conflicting interests, an objective which is not consistent with maximizing the efficiency of the system.

While recognition of such problems is important, this analysis still represents only part of the story. These costs, considered by themselves, are not a sufficient indictment of the administrative process, nor does a recitation of other values that regulation seeks to serve constitute an adequate justification. Rather, the features inherent in the regulatory process are simply one set of factors that need to be taken into account when deciding whether regulation is worthwhile, or whether some other method, with perhaps a different combination of equity and efficiency in its process and outcomes, is preferable.

In considering the future of regulation, the Panel was particularly troubled by one characteristic of regulation—its adversarial nature. The regulatory process frequently tends to pit one group squarely against another, each side insisting that its position is correct. This atmosphere of hostility and suspicion hinders attempts to improve regulation. Regulators, businesses, and other groups participating in the process too often see each other as opponents instead of partners in furthering national goals. The adversarial nature of regulation undoubtedly contributes to the alarming growth of litigation as the foremost means of resolving conflicts.

The Panel believes that it is possible both to reduce the adversarial nature of the debate and to improve the overall quality of regulation. In writing the report, it sought to serve these goals in three ways: first, by pointing out the many deficiencies in the discussion of regulatory issues; second, by presenting an analytical framework within which a particular regulatory issue may be considered; and third, by examining alternatives to the regulatory process that could produce better results.

The Panel's concern has led it to expand the scope of the report beyond what has been considered by others who have written about regulation. The report is not limited to an examination of controls on business activity, the traditional focus of regulatory policy. While the report does discuss controls on prices and profits, requirements that businesses disclose information about their products or practices, pollution abatement activities, and regulatory efforts to reduce the hazards to health and safety from products and workplaces, it also examines government interventions into what many people regard as matters of personal

morality and values, such as prostitution, pornography, homosexuality, drug use, and gambling. The reason for including both areas is the commonality of rationales and methods for intervention. This commonality is rarely recognized and even less often explored for the purposes of clarifying thought about the appropriate scope of intervention by government into private decisions.

The second way in which the report is broader than might be expected is that it examines a wider array of methods for controlling or influencing private behavior than those traditionally used by regulators. Because of statutory constraints and other reasons, regulators have most frequently resorted to command-and-control requirements to control business conduct. A host of alternatives exists, including: disclosure requirements; use of policies such as antitrust laws to foster more competition; and reliance on subsidies or taxes to create incentives for businesses to change their behavior. A comprehensive and sophisticated examination of these choices is important because it may help the nation select more satisfactory solutions to some of the problems it experiences with government regulation.

The Panel's report on government regulation is divided into two principal sections. Part A, Chapters 2 through 5, discusses the Panel's analytical framework for deciding questions regarding the appropriateness of various forms and uses of regulation. It contains some suggestions for improving the method of addressing the three essential inquiries in this area: why government intervenes; what are the means available to achieve the desired ends; and what level of government—federal, state, or local—is most effective in achieving them. This section of the report also examines the increasingly important topic of what governments should do in the face of admitted uncertainty.

Part B, consisting of Chapters 6 through 11, looks into the future. It asks the question: what areas will be and should be on the agenda for increased regulation, for deregulation, or for different forms of regulation? It also reviews some of the current trends and proposals—approving some, disapproving others, and raising questions about the limits of still others. Chapter 11 contains a brief discussion of government regulation of non-business activities. It examines such forms of government intervention in private decisions as laws involving gambling, marijuana, private consensual sexual activities, and mandatory helmet requirements. The report points out parallels between these rules and those involving commercial activities and suggests that the analytical framework, although not necessarily the results, should be similar for both.

Many people assume that government regulation is a recent phenomenon, but in a sense it is as old as society it-

self. Since ancient times, laws have been used to decide disputes among individuals with competing claims to property, asserted rights under a contract, and claims for protection of the person. Thus, when people could not agree, society, through its court system, was available to settle controversies. If government officials did not approve the result, they would write new laws to govern future disputes. That kind of government activity could, broadly defined, be considered government regulation, especially when the prohibitions imposed by the criminal law are included.

The Panel believes, however, that there are sufficient differences between the common law and earlier statutes on the one hand, and government intervention beginning perhaps a century ago on the other, to warrant special treatment for the latter. In contrast to what happens in the court system, much government intervention takes place before the disputes arise rather than after. For example, the laws of nuisance that were developed to protect against infringements on property operate after an injury has taken place. In contrast, government control of pollution, today's regulatory counterpart to nuisance law, aims to prevent unwarranted substances from entering the air or water so that no dispute will arise between a polluter and the property owner or ordinary citizen.

Related to the difference in timing is the greater emphasis today on prevention rather than on compensation. While one of the aims of traditional laws providing compensation is to deter the conduct giving rise to it, that function is clearly secondary. By way of contrast, government regulation attempts to prevent undesirable occurrences and thereby to eliminate the necessity for compensating injured persons. Moreover, under modern government regulations, there is no need for a private beneficiary to initiate the government activity; regulation is applied regardless of the beneficiary's consent to the prohibited transaction or even over his objection. As an example, workers or their union may not lawfully bargain away protections afforded by government minimum wage or occupational safety laws.

For these reasons, the term "government regulation," as used in this report, refers only to those activities of government that are active rather than passive, that are primarily forward-looking rather than compensatory in nature, and that seek to do more than define the rights of parties in the absence of an agreement between them. However, it is important to remember that regulation coexists with a large body of law that antedates it. Nonetheless, society, for one reason or another, has found this body of law inadequate and has passed other laws requiring the government to assume a more active role in society. Therefore, this report first considers why governments have decided to regulate.

Before turning to the rationales for regulation, it is important to provide a working definition of the term, "government regulation," not simply for semantic reasons, but to avoid confusion. The term has at least two meanings. First, it describes government intervention in what are ordinarily perceived to be private decisions, including those made by both corporations and individuals. Such intervention either prohibits certain conduct or conditions it on compliance with certain requirements. Thus, for example, manufacturers may be forbidden from discharging wastes into the local river, or a pharmaceutical company may be denied the right to sell its drugs unless their safety and efficacy have been approved by a government agency.

The second use of the term "government regulation" refers to the issuance of standards either directing precisely the activity permitted (or forbidden) or establishing some other requirement. In this sense, the term is equated with the establishment of government standards, commonly referred to as rules or regulations. Used in this manner, the term refers to one alternative method of achieving certain ends deemed desirable by government policymakers.

The Panel recognizes that the term "government regulation" can properly be used in both senses. However, for clarity, it has decided to use it solely in the former sense (i.e., government intervention). When the latter meaning seems appropriate, it uses such phrases as "standard-setting" or refers to the rules as "command-and-control regulations."

PART A

An Analytical Framework

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Chapter 2

Rationales FOR Regulation

The basic decision on whether the government should intervene in the private decisions of businesses or individuals is made by elected legislators who have many items on their agendas and numerous requests for action. Therefore, it is almost inevitable that some more or less dramatic event or series of events is required to motivate a legislature to act. When it does, there are two broad rationales for regulation—equity and efficiency. Regulation generally involves both of these rationales.

The first rationale involves purely equitable considerations, with discrimination based on characteristics such as race, sex, or age as the most obvious example. Discriminatory practices may be economically wasteful, but, by and large, their economic origins and effects are irrelevant in deciding whether to regulate. At least for some individuals, the debate over such environmental topics as preserving the wilderness, protecting endangered species, and cleaning the air and water involves the same equity issues. Whether discussion centers on an assertion of rights, the unfairness of corporate activities, inequality, or injustice, the fundamental dispute is about the way rights have been allocated by society. It is not that economic considerations are irrelevant. Rather, the proponents of the legislation do not regard them as the most important aspect of the problem. It is the Panel's view that policymakers need to recognize both what motivates those seeking government intervention through regulation, and the limitations caused by such motives, which have a direct bearing on the means of advocated to achieve the desired goals.

The second rationale for regulatory programs today is the failure of the marketplace to account properly for all important social and economic values. The term often used is "market inefficiency," which is another way of saying that the total cost to society (and not merely the manufacturer) of producing a particular product may be higher than necessary, or that its market price may not reflect either the value of the product to the consumer or the costs imposed on other elements in society of producing it. This

chapter first examines the justifications based on economic market failure and then returns to the question of inequality, since many claims involving equity arise from problems of market failure.

Rationales Based on Market Inefficiency

Over 200 years ago, Adam Smith identified the conditions that must be present for a market to work efficiently. One is that every buyer faces many sellers, and vice versa, so that bargaining power is equalized. Then Smith's "invisible hand" will work: the profit motive will force prices down to the cost of production (including the minimum profit necessary to keep sellers in business), as each seller cuts prices in an attempt to increase sales. Some markets may be controlled by only one seller, creating a monopoly. In the case of a monopoly, the profit motive leads a business to restrict output and to charge higher prices in order to maximize profits. This situation is inefficient because some people who are willing to pay at least the production costs (including a normal profit) are excluded from the market by the monopolists' higher prices. The first line of defense against monopoly is the antitrust laws, which seek to prevent or to dissolve monopolies so that a competitive market can exist. Antitrust laws differ fundamentally from other forms of government intervention because they do not seek to change competitive behavior to produce other socially desired results, but only to preserve competition. Indeed, the vigorous enforcement of the antitrust laws is generally considered to be an indispensable element of deregulation or of a decision not to regulate.

In some instances, a single firm may be able to serve the entire market more cheaply than could several firms in a competitive market. This is a natural monopoly. In such a case, an alternative to antitrust enforcement is to control the prices of the monopoly in order to capture its cost advantages, while preventing the monopolist from charging monopoly prices.

Natural monopoly is the standard rationale for regulation of public utilities. Because antitrust policy seeks to eliminate monopolies, while public utility regulation seeks to preserve but control them, the two programs are periodically in conflict. In deciding whether to regulate or to rely on competition, the policymaker must determine whether the monopoly provides a true cost advantage and, if so, whether regulation will lead to a combination of prices and quality of service that are preferable to the likely results under unregulated competition. The current legislative and legal debates about telecommunications policy illustrate this conflict. One side argues that a major part, if not all, of telephone and related services is a natural monopoly. The other side says that many, if not most, services can be

provided efficiently in a competitive market. It argues further that the economies of scale that hold costs down are not great enough to be important. Even if scale economies are significant, consumers might value a single homogeneous service less than they would a diversified system that offers services with differing characteristics, even though these services are more costly to produce. Similar debates have occurred over railroads, airlines, trucking, electricity generation, and even major league sports franchises.

Where a natural monopoly does exist, the alternatives to public utility regulation are few. Other countries have nationalized these industries, but Americans have found this alternative appealing only in the case of a few public utilities such as the Tennessee Valley Authority and municipal water companies. Another alternative is to permit a private company to act as a monopoly for a limited period and to award that permission on the basis of competitive bidding over prices and services. While local governments have used this method to allocate the right to provide cable television service, the long-term character of most investments by utilities makes this option unattractive.

A second condition for Adam Smith's invisible hand, and a prerequisite for markets to work efficiently, is that the producer must pay the full price in the competitive market for each resource, including labor, that is used. This condition obviously does not hold if people who are not directly involved in the production or purchase suffer adverse consequences from the transactions of others—so-called "third-party effects" or "spillovers." An important class of resources has this property: the use of the environment to dispose of waste. Clean air and clean water are valuable resources to society which, when given away free, are overused. In the absence of government controls, companies use the airsheds and waterways to dump their waste products without paying for the privilege. Their actions create social costs for third parties, who in effect end up paying for part of the true production cost of the product, even though they are not consumers. Meanwhile, the sales price of the product fails to reflect its true social cost. Environmental regulation attempts to overcome these inefficiencies by forcing firms to pay these costs and thereby to conserve the environment, just as they conserve other costly resources such as capital, labor, land, etc.

The obstacle to establishing a normal market for the environment is that there is no convenient way for people to express to a potential polluter the value they place on clean air and clean water. Everyone who lives in an air basin or who uses a clean river is affected equally by its debasement, and it is not practical for them to coordinate their actions to determine how much pollution, if any, they

are willing to permit. For this reason government intervenes to represent the affected parties. In doing so, it attempts to shift the costs of pollution from third parties back onto those whose activity causes it.

The decision to intervene is only the first step in the process. Assuming that the policymakers are able to agree on how much pollution should be allowed, there is still the task of choosing the most appropriate method for achieving that end (discussed more fully in the next chapter). Briefly summarized, in this situation, the choice would be among the following: (1) specifying the technology that polluting firms must use to abate their emissions; (2) setting an upper limit on each firm's emissions, but letting the firm pick the technology for achieving that limit; (3) taxing the emissions of the firm at rates which create a sufficient incentive to reduce emissions to an acceptable level; or (4) developing a system of tradable emissions permits that establishes total permissible emissions in a region, and then allows firms to develop a market for these permits based on decisions by each as to how best to minimize the sum of expenditures on emissions permits and abatement costs. The latter two approaches are market-like, in that decisions by firms determine the distribution of abatement among them, whereas the first two are more conventional, consisting of specific commands to each business on how it should operate. However, all four require, as a first step, a political decision to pursue a policy objective through nonmarket means so that a valuable resource (the environment) can be safeguarded.

Adam Smith's third condition for the "invisible hand" is that people possess sufficient knowledge about the characteristics and consequences of products and workplaces to make rational decisions. Inadequate knowledge can lead workers to take jobs with hazards they would not normally accept, or consumers to buy products with characteristics that they would not purchase at the going price if they were informed.

A task of public policy is to determine whether there is insufficient information for an efficient marketplace and whether government has an effective remedy that would justify intervention. Information problems can range from relatively infrequent mistakes to persistent patterns of bad decisions by workers or consumers, coupled with some firms consciously developing strategies to profit from the misinformation. The Securities and Exchange Commission and the Federal Trade Commission, in the securities and consumer fields respectively, were established to deal with just these sorts of problems.

Several approaches can be used to remedy problems of inadequate information. They include criminal law, civil liability law, informational requirements, business taxes

on injuries and illnesses associated with products and work, and direct regulatory intervention to specify minimum standards for products and workplaces. The first two options rely on the market to carry most of the burden of producing an acceptable outcome, with the law available for the occasional "bad actor." Informational requirements and taxes also rely on the market to work—once consumers or workers are adequately informed, businesses will have adequate incentives to avoid damaging them.

However, even where the market failure is due to a lack of information, additional data may not be a sufficient remedy. Those who favor control over the quality or dangers of a product focus on prevention of injuries (either economic or health) rather than on compensation and punishment. They also express doubts about the effectiveness of an information strategy, especially when the material is technical or the recipient is uneducated or otherwise unable to appreciate the impact of what is being communicated. The argument on the other side is that regulation, because it is relatively specific, cannot reasonably be expected to cover all, or even most, hazards. Some argue that the incentive provided by the prospect of punishment and compensation could lead to greater prevention than regulation would. The Panel believes that there is no single correct answer to the question, with the appropriate choice among policy options dependent on the specific nature of the informational problem.

Perhaps the area in which legislatures most often determine that information alone will not suffice is occupational licensing, which has the purpose of protecting the consumer from unqualified doctors, lawyers, real estate brokers, and, in some states, even barbers and television repairmen. There is agreement that no one should be able to misrepresent his or her education, training, or skills, but occupational licensing laws go further by preventing an unlicensed person, who truthfully discloses his qualifications, from providing alternative and often less expensive services, no matter how well-informed the consumer is. Such laws, which are in effect designed "to protect us from ourselves," are among the most rigid forms of standard-setting. They are being increasingly viewed as anticompetitive, both because they create excessive barriers to entry and because they deny consumers a choice among competitors, only some of whom are licensed.

Equity Rationales

The preceding discussion has focused on efficiency in market performance. However, the equity of market operations also plays an important role in decisions to regulate. In this context, equity refers to the distribution of rights in society and of the income and wealth of its mem-

bers. Government is often asked to define these rights more precisely, to alter them, or to resolve conflicts among them. A common example involves skyrocketing land prices and rents at prime locations in large, growing cities. Citizens often demand that government impose rent controls and take other actions to prevent "speculation" in property. Another illustration is the political movement to hold down domestic oil and gas prices, rather than allowing them to match international prices. The issue in both cases is whether to allow the owner of the resource to make "windfall" profits that result from dramatic increases in prices caused by scarcity. The alternatives are to control profits by regulating prices or to tax away the windfall. The former policy creates inefficiency, because it causes a scarce resource to be used excessively and by those who do not make the most valuable use of it. The latter does not remove the economic burden on the groups whose interests the government seeks to protect unless the windfall tax is distributed back to them.

Normally firms can expand production of renewable resources or services relatively easily and inexpensively in response to increased public demand. In contrast, supplies of nonrenewable resources are fixed. If demand begins to approach the total availability of the resource, prices can move upward rapidly without bringing forth increased production. Thus, soaring property values in Manhattan do not increase the amount of land available, and rising oil prices, while making production of some reserves profitable, do not alter the fact that the amount of recoverable oil is fixed.

A second equity rationale for regulation is to guarantee the distribution and availability of services that would otherwise not prevail. The strategy is to allow firms to earn excess profits in one market if they agree to serve another that loses money. A defense of airline and truck regulation is that it makes possible the provision of necessary services to small communities. This approach uses regulation as an alternative to taxes and subsidies, letting the firm do the subsidizing internally. The problem with such a scheme is that without competitive bidding for the right to serve a subsidized route, the government never knows for sure what the appropriate amount of the subsidy should be. Moreover, internal subsidization raises another equity question—why should users in one market pay for services to people in another market? Finally, if several firms operate in the regulated market in which there are supposed to be excess profits, companies will still compete by offering excessively elaborate service, which raises costs and undermines the revenue available for subsidizing other markets.

It is not always the consumer or the small community that invokes equity as a basis for regulation. Sometimes

particular economic groups seek the aid of government to protect the markets for, and hence income from, their goods or services. Government sometimes chooses to redistribute income either through direct subsidies or indirectly through tax preferences. In other cases, it constructs market rules that favor particular groups and bring about changes in their income. An example is the agricultural cooperative law, which allows certain categories of farmers to band together to reduce competition in the sale of their products. Sunkist, a cooperative marketing organization that includes nearly all citrus growers in California, maintains high domestic prices for fresh oranges by restricting sales to the retail market and dumping excess production on orange juice manufacturers and on the international market. Without a special statutory exemption, the Sunkist combine could not legally engage in those activities.

In numerous cases, public policy debates about regulation involve two strongly opposed sides. One side claims that regulation serves one of the general efficiency or equity purposes cited above, while the other claims that the proponent's motive is solely to reduce competition among sellers. Does occupational licensing guarantee high quality service, or simply restrict the number of people in the occupation so that each earns a higher income? Does transportation regulation increase service to small communities, or does it limit competition, leading to some combination of higher profits and excessive service competition? Policymakers need to confront issues such as these in making the decision whether to regulate.

Perhaps the clearest case of an equity rationale for regulation is discrimination based on race, sex, national origin, or other qualities unrelated to merit. The civil rights laws enacted over the last 30 years were passed because of a recognition that discrimination was morally wrong and that it was the duty of government to end it. Note, however, that even discrimination can be viewed in economic terms. Denying certain jobs to qualified people for extraneous reasons cuts down on society's productivity, creating unnecessary bottlenecks in the protected occupations and unnecessary gluts in the occupations that remain open to those who are the victims of discrimination. Thus, it is not only unfair, but inefficient as well, to assign members of racial minorities to low-skill occupations and to persist in relegating most female employees to the steno pool.

The debate over alternative policies to end discrimination focuses on the most effective way to promote the greatest entry of women, minorities, and the handicapped into higher status jobs. The regulatory approach requires good-faith attempts by firms to hire people who have previously been excluded. A market-based alternative relies

more on providing the disadvantaged with better education and job-training. The premise of the latter strategy is that poor educational programs produce too few qualified candidates for the best jobs, a barrier that affirmative action at the hiring stage cannot overcome. Proponents of regulation, on the other hand, believe that affirmative action is necessary to break down entry barriers. Those who obtain jobs will in turn serve as role models for others. While both sides agree that the roots of the problem are discrimination somewhere in the system, the disagreement is the familiar one of whether markets can work to equalize employment opportunities for qualified job seekers.

Similarly, the issue of pollution, which was discussed earlier from an economic perspective, is viewed by many as an issue of equity or "rights." From this vantage point, the principal reason to regulate is not that the polluter has not paid for dumping chemicals into rivers, but that the company has no "right" to deprive residents of clear water for swimming, fishing, or other recreational purposes. Those who seek to preserve the wilderness are not in conflict with the mining companies over inadequate compensation, but over their continued desire to see the resource used for purposes other than development.

These examples of discrimination and pollution have convinced the Panel that an appreciation of both equity and economic perspectives is essential in answering the question of whether to regulate and in dealing with the next question of how best to carry out the program once a decision to intervene has been made.

Chapter 3

Options AVAILABLE TO Achieve Regulatory Goals

In recent years, alternatives to traditional regulation—making and enforcing rules in an administrative proceeding—have received substantial attention. The reason is that regulation is widely perceived as being inefficient and/or ineffective in some important areas of public policy, a perception which in some instances contains a significant element of truth. If the objective of a regulatory program is important, the alternatives may seem to be either to abandon an important policy objective or to pursue it with a costly, ineffective instrument. This dilemma, however, is more apparent than real because it ignores the possibility of using more efficient regulatory tools. Future public acceptance of government intervention in private decisions will depend largely upon finding the most appropriate method through which to operate. This chapter focuses on the alternative strategies available in three broad areas of regulation—prices and profits, entry into the marketplace, and the quality of products and processes.[1]

Price and Profit Controls

Government, for reasons of equity and perceived market inefficiencies, often tries to control prices and profits.* Some of the methods for doing this are quite common. Others are used only infrequently. Methods available include: cost-of-service ratemaking; historically-based price regulation; windfall profits taxes; subsidies; competitive bidding for monopoly rights; and nationalization.

Cost-of-service ratemaking has most often been employed in public utility price regulation. Its nominal objectives include: first, and most important, preventing excess profits by holding prices down to costs plus a "reasonable profit"; second, avoiding waste in the allocation of resources; and third, eliminating inefficient production methods. Sometimes the objectives also include the

*Occasionally government will attempt to raise the price of a good or service by taxing it in order to discourage some activity. This technique is discussed on p. 24 of this chapter.

prevention of price competition to protect weak firms and the indirect subsidization of certain classes of customers. When these goals are being pursued, cost-of-service ratemaking is often used, in conjunction with licensing, to control entry of competitors into the regulated market.

In theory, cost-of-service ratemaking seems comparatively easy to administer. The regulator selects a test year and combines that year's operating costs, depreciation, and taxes. To this is added a reasonable profit, determined by multiplying an appropriate measure of the competitive rate of profit in similar industries by either total costs or the current value of capital investment for the regulated firm. The firm's revenues then become the sum of profits, depreciation, and operating costs, with prices set to yield the required revenue. If a firm produces several products or serves several distinct groups of customers, the regulator must also decide upon a "rate structure," or the specific prices to be charged for each product or group.

In practice, cost-of-service ratemaking is inherently problem-ridden. Regulators must constantly fine-tune a process designed to act as a reasonable facsimile of the marketplace, but without benefit of the incentives created by a normal price system. There is little incentive to reduce costs, as in a normal market, where profits are enhanced by lower costs. On the contrary, under cost-based regulation, profits can increase if costs go up. Moreover, regulators face great difficulty in collecting adequate information to determine what is the appropriate rate of return, or which costs are "excessive" or "unnecessary" and hence should be excluded in calculating a firm's revenue requirement.* In sum, regulators simply cannot know much of what they have to know in order to recreate the results of a competitive market.

Another approach is **historically-based price regulation,** under which future prices and wages of many firms with disparate costs are tied to their wage and price levels on a specific date in the past. This is the traditional approach when nationwide wage and price controls are imposed, but it is occasionally proposed for specific industries, as illustrated by the proposal to put a cap on the annual rate of increase in hospital prices. This system tends to respond poorly to changing conditions within and among firms and thus is useful only for short periods. In addition, the incentive to evade regulation (by changing the product, by selling in unregulated markets, or in some instances, by violations) can be quite strong.

*One particularly difficult aspect of cost-of-service ratemaking is allocating costs and capital among the different products of a firm, especially when the prices of some products are controlled, while others are not.

Another regulatory technique for controlling profits (though not prices) is a **tax on "windfall profits."** It is usually applied when the scarcity of a good drives prices up sharply. Under this approach, the government taxes away an additional part of a business' profits beyond that applicable to other businesses, and in some cases rebates the proceeds to those most hurt by the sudden price jump. The technique allows the market forces of demand and supply to determine prices, which in turn determine allocation, with government intervention occurring only after the market operates.

The windfall profits tax is not trouble-free. Determining the appropriate tax is a delicate process, raising the same kind of problems as cost-of-service ratemaking. There is a tension between the objectives of equal treatment of firms and ease of administration. Implementation of the tax is facilitated by grouping firms in broad categories. But firms vary tremendously and should be taxed in relation to their particular characteristics. Otherwise, some firms will retain some of the windfall, while others may be put at a serious disadvantage. If the agency tries to grant exceptions to improve equity, administration of the program will grow increasingly complex.

There is an additional problem. Taxes take wealth from one group, presumably for some use, which raises the issue of how to dispose of the revenue. Rebates raise questions of practicability—how can the equity objective of aiding those harmed by the higher prices of a scarce good be achieved, and can it be done without destroying the incentive to reduce consumption of the taxed item?

Another, less common way to relieve the burden of high prices is through **subsidies** to those who are particularly disadvantaged. Rather than artificially holding down the price of a good or service, the government, in effect, props buyers up with some kind of financial assistance. Again, the problem is that subsidized buyers lack an incentive to reduce consumption in the same way that they would if they had to pay the true cost of the good or service in question.

The government can also control prices by taking over a business—that is, through **government management.** Such industries are comparatively less popular in the United States than elsewhere, and they have been established only in a few cases (e.g., the U.S. Postal Service, the Tennessee Valley Authority, and municipal water, power, and local transportation companies). The economic efficiency of an enhanced role for nationalized industries in the United States has not been systematically studied. Some claim that a government-managed firm could perform as well as a privately-owned business and point to TVA as an example. Others argue that such a firm would

be subject to political pressures that would reduce its efficiency. (The political difficulty of closing underused post offices or combining inefficiently small municipal utilities are oft-cited examples.) Moreover, government-controlled firms sometimes deliberately restrain prices and survive on subsidies which can lead to the kind of overuse associated with a subsidy or tax rebate program.

In the case of monopolies, regulators can control profits by using **competitive bidding** to award temporary monopoly rights to those firms which promise to provide the better service at the lowest price. The military uses this technique to determine which defense contractors will build a new weapons system. The difficulty with this approach is that the government rarely knows in advance the true cost of a commodity or a service; thus companies systematically understate their costs in order to get awards (known as "low balling") and then request compensation for cost-overruns. This is normally paid because, for monetary and programmatic reasons, the government cannot afford to cancel the agreement with the winning firm, nor can it allow the firm to declare bankruptcy. If the quality of the service or product is also specified in the contract, additional problems emerge regarding enforceability.

Antitrust laws were one of the earliest efforts by government to control prices, dating back to 1890. The Sherman Antitrust Act, now 90 years old, was designed to maintain a competitive market by prohibiting firms from agreeing with competitors to set prices or divide markets. Subsequent legislation has banned specific trade practices because they are likely to have undesirable effects on consumers or other competitors. Because these acts seek to preserve competition without otherwise changing existing relationships, they can do little about a natural monopoly, except when that monopoly acts in a predatory fashion.

The existence and effective operation of antitrust laws are prerequisites for the deregulation program described in Chapter 7, yet they have limitations. For example, major antitrust cases are very expensive and time-consuming to litigate. Thus, even effective antitrust enforcement will never completely replace other methods of dealing with the problems of inefficiency and inequity.

In summary, all the regulatory tools for controlling prices and profits have problems with implementation, and none can be expected to work perfectly. These problems, in part, have lead to a reexamination of the desirability of governmental control over prices and profits. As indicated in Chapter 7, most people in this country would agree that the time has come to end most economic regulation of this sort.

Controls over Entry into the Marketplace

In a variety of circumstances, government controls entry into the marketplace by forbidding an activity without a government-issued license. It does so in order to achieve results that fall into two broad categories. First, licenses are often used as part of a regulatory program designed to control prices, products, and processes. The rationale for licensing in these cases is to ensure minimum standards of service, as in occupational licensing, or to allow regulation to subsidize a service in one market by creating excess profits elsewhere. In these cases, licensing is used to limit competition among firms by controlling entry into markets.

The second category, discussed below, includes situations in which the government has a scarce resource to allocate, such as concessions in a public park or the use of the electromagnetic spectrum for various communications services, and it must decide among minimally qualified competitors. In such cases there are various techniques used to allocate resources—the "public interest" standard, the auction, and the lottery—and this section discusses their strengths and weaknesses, which depend on the nature of the resource and the conditions established by the license.

Allocation according to a "public interest" standard is one tool. It is used by the Federal Communications Commission (FCC) in granting broadcast licenses. Unfortunately, statutes are notoriously vague about what constitutes the public interest. As a result, regulators may be unduly vulnerable to subjective definitions of the term being pushed upon them by affected parties. Without criteria that clearly identify the most deserving of the competing applicants, results appear to be inconsistent. The FCC responded to this problem by developing detailed, but unavoidably subjective, criteria. However, it failed to determine how the criteria would be weighed in reviewing applications, and hence the greater predictability that was sought did not materialize. Despite these problems, the current system persists because Congress has been unwilling to allow vital assets such as television channels to go to the highest bidder, with no effort to require adherence to some broad concept of the public's need.

Another solution, which the Federal Aviation Administration is now considering for the allocation of landing rights at major airports, is to **auction** franchises of limited duration. The agency establishes the duration of the franchise and the minimum standards for the good or service and then sells some predetermined number of franchises to the highest qualified bidders.

This method can work successfully if the franchised rights are relatively plentiful or easily interchangeable (such as the right to land at O'Hare Airport between 7:00 a.m. and 8:00 a.m.). It is more difficult to implement when the franchise, such as a television station, must make

long-term capital investments to provide the service. A firm that loses the auction after a previous win can find itself with a massive capital investment that cannot be used for other purposes and that is of no value to anyone other than the new licensee, whose superior bargaining position would enable it to purchase the assets at well below replacement cost. For an auction system to work in such a situation, regulators must either specify a transfer price at which the new licensee will purchase the assets or make the duration of the license long enough to allow the investments to be recouped. It is the problem of the loss of investment, coupled with the reluctance of regulators to shift from a proven licensee to one who is offering only promises, that accounts for the Federal Communications Commission's extreme reluctance to deny renewal.

Finally, the government can use a **lottery** to determine who enters a particular market. This device is used by the Bureau of Land Management to allocate mineral rights on public lands and was recently proposed as a way to decide which of several qualified applicants would receive a license for a vacant radio channel. If the cost of preparing an application is significant, the randomness of a lottery could discourage the kinds of applicants that regulators would normally choose because it lowers their chances of success. A lottery is, however, exceedingly easy to administer and reduces the costs of both regulators and applicants.

Product and Process Quality Controls

Much of government's important regulatory activity is directed at controlling qualitative aspects of a product (the safety of an airplane or a drug), of the process for producing it (the level of pollution emitted by a steel mill), or of a service (the competency of lawyers). Once a decision has been made to intervene in the market for one of these purposes, there are a number of alternatives that might achieve the desired goal. The most important are input standards (often known as design standards); performance standards; disclosure; taxes; marketable permits; and unregulated markets policed by the law of contracts and torts. Each has its advantages and disadvantages, many of which are overlapping. With very few exceptions, it is legislative bodies, and not regulatory agencies, that determine what regulatory techniques will be used.

Whoever makes the decision concerning the appropriate tool should recognize that they differ in at least three important respects: (1) the extent to which they create incentives for compliance; (2) the ease with which they can be administered and enforced; and (3) the costs they impose, including the effects they have on other aspects of efficiency and equity in the market for the regulated products.

One note of caution is in order. In theory, the same result should be attainable with the various regulatory techniques. In practice, a number of factors, discussed below, will affect the actual result for better or worse. The techniques differ in terms of their enforcement costs, the direct costs that they are likely to impose on regulated firms, and their predictability in terms of both the extent to which they will achieve policy objectives and their compliance and enforcement costs. Ultimately, the magnitude of the improvement in environmental, health, and safety conditions in society will depend on the effectiveness and costs of the techniques adopted—better techniques will permit more ambitious goals. Meanwhile, the adoption of better techniques will tend to be resisted by businessmen, environmentalists, and other concerned groups if their effects are uncertain. An essential part of reform in this area is detailed analysis that narrows these uncertainties.

Input standards establish the specific methods that each firm must adopt to deal with the problem that gave rise to the regulation. On the positive side, input standards let both regulators and firms know precisely what the firms are to do. The standards are usually easy to enforce, since one can simply observe whether a specific technical solution is in place. Furthermore, the cost of compliance is usually known reliably enough in advance so that regulators can avoid regulations that impose severe economic hardships. Because of these administrative advantages, input standards often emerge as the technique of choice by regulators, even when legislation is directed toward performance measures. For example, the Clean Air Act is written in terms of goals in air quality; however, in many cases, it has been implemented by establishing input standards for major sources of pollutants.

Input standards have several weaknesses. Their use presupposes that the regulator can deduce the course of action that, if followed by all regulated firms, would best achieve the overall objective of the regulatory policy. Thus, a regulator must know how the burden of achieving certain standards should be shared and what modifications each firm should make in its production methods. This requires a detailed knowledge of all affected firms, as well as an ability to predict precisely what effects a design modification will have on obtaining the regulatory goal.

Of course, regulators rarely possess such complete information. As a result, input standards are frequently less than ideally efficient, and they sometimes are less effective than initially expected in achieving the overall objectives of the regulation. Moreover, they do not necessarily mandate the least expensive methods for achieving a change in performance. Indeed, because exceptions must

be approved through a formal regulatory process, they erect barriers to the introduction of less costly methods and cost-reducing innovations.

Performance standards specify the level of performance or improvement to be achieved by each firm, but let the firm decide how the improvement is to be attained. In comparison with input standards, performance standards, if effectively enforced, reduce uncertainty as to, for example, the amount of pollution produced, since the standard specifies the outcome. There is, however, increased uncertainty as to the feasibility of the regulation and the cost of compliance. If performance and input standards are designed to achieve the same objective, the former will generally produce lower costs because firms will have an incentive to achieve the desired performance as inexpensively as possible, an incentive lacking where the regulation dictates the method to be used.

As with input standards, the success of performance standards depends on the regulator's ability to predict. However, with performance standards the task is to be sure that the performance is technically attainable, that it will achieve the regulatory objective, and, where cost is relevant, that the expense is reasonable. Thus, for example, in controlling the sulphur emissions from a utility, the agency tries to set emissions standards that are feasible, that are consistent with overall air quality objectives for the affected region, and that do not impose an extraordinary expense on the company.

Uniform application of performance standards creates other problems. Thus, because not all steel mills are the same age or have the same design, a performance standard may be more difficult and/or costly for some firms to achieve than for others. This situation may produce differences in compliance costs or requests for delays or variances that lead ultimately to a complicated system of firm-specific regulations. Performance standards can also be difficult to enforce because they require monitoring of the conduct of the regulated firm frequently enough to make possible a reliable estimate of compliance.

Standards of either kind may be undermined by the inadequacy of the data on which they are based. Obtaining the needed information can result in an undesirable reliance on either the interest being regulated or an excessively large agency staff. In addition, both kinds of standards are inherently biased against innovations in processes and products; a company has little incentive to search for cleaner or safer production technology than government regulators require. Standards can also affect competition within the regulated market by substantially raising entry and transaction costs. Occasionally they even have unintended consequences, as illustrated by

> . . . the selection of a bumper standard [for automobiles] requiring no dent in five-mile-per-hour crashes [which] would favor rubber bumper manufacturers while a standard allowing slight dents would keep steel bumper manufacturers in business.[2]

Finally, both kinds of standards are rarely made rigorous enough to force firms to relocate or to cease a production activity, even though the least expensive solution to a social problem, especially in environmental policy, may be to remove a few particularly troublesome firms, rather than to require all of them to make improvements.

Another regulatory alternative is to allow industry to do what it wants, but to require full **disclosure** of the potential harm or risk that each firm generates: a business may continue its somewhat risky operations so long as it fully informs employees and customers of any potential hazards. The great appeal of this method is that it preserves corporate and individual choice—workers or consumers may evaluate for themselves the risks that attach to some task or product. Further, many of the costs and uncertainties associated with traditional controls do not arise. Government regulators are not placed in the difficult position of anticipating the market or of manipulating it through policies based on inadequate information.

Still, disclosure is not entirely free of administrative problems. Regulators must decide how and to whom information is to be disclosed. In some cases, however, the act of collecting and disseminating the information in the required form can be quite burdensome, as are some campaign disclosure laws and the registration requirements for small businesses selling securities. Moreover, disclosure cannot be expected to overcome powerful incentives acting upon both buyers and sellers to ignore important social values that cannot adequately be expressed in unregulated markets. For example, disclosure will normally prove ineffective in dealing with environmental problems, for consumers cannot be expected voluntarily to purchase a substantially more expensive brand of a product that was produced in a more costly but less environmentally destructive way.

Disclosure requirements are most attractive when relatively simple information can improve the ability of consumers and workers to make rational choices. Then, the main advantages of disclosure—greater flexibility and conduciveness to innovation—can be determinative. Examples of the appropriate use of the technique of disclosure are: the Food and Drug Administration's labelling requirements, the truth-in-lending laws, and the Civil Aeronautics Board's regulations requiring that airlines inform passengers in advance about the possibility of being bumped from flights.

Perhaps the most significant question about disclosure is whether society has an obligation to intervene if some citizens do not have the competence to evaluate the information provided them or choose to ignore it. Can people, unschooled in the risks associated with the use of a drug or pesticide, be allowed to use it as they please when the information is highly technical or if misuse could have serious, even fatal, consequences? Alternatively, should some people who are able to make informed judgments be prevented from doing so because others are not?

Another alternative which has received considerable attention as a substitute for input and performance standards in the environmental area is the use of **emissions taxes.** If the cost of discharging chemicals into a river is subject to very high taxes, the polluter may look for another way to dispose of its wastes in order to avoid the tax. One of the principal advantages of a tax is the flexibility that it gives to regulated firms. A firm facing an emissions tax will seek to minimize the sum of its abatement cost and its emissions taxes. If a firm can abate a substantial amount of its pollution at a relatively low cost, but faces steeply rising costs if it is forced to abate more, it can elect to avoid the latter by paying taxes on some emissions. If the tax rate is chosen so that the cumulative emissions of all firms meet overall pollution standards, the result will be the achievement of pollution standards at minimum total costs. Moreover, unlike standards, emissions taxes give polluting firms a continuing incentive to reduce discharges as a way to cut costs.

Nevertheless, taxes are not panaceas. In many ways, it is just as difficult to determine the precise tax rate that will induce a certain change in behavior as it is to set the appropriate performance standard that a company must meet. There are also significant enforcement problems, since it is the plant, not the tax return, that must be monitored to assure the firm is paying the proper tax.

In some cases, an agency may establish a fixed number of permits, giving access to a resource or setting conditions on the amount and nature of its use, but allowing the marketplace to decide who gets the permits. One potential area of application for **marketable permits** is pollution control. Environmental regulators are currently experimenting with two limited forms of marketable rights, the **bubble concept** and the **offset policy.** The bubble concept sets an overall limit on pollution from one factory, rather than controlling the emissions from each pipe or smokestack. Each firm can then allocate its resources freely so long as its total emissions are below the required level. The offset policy permits a firm to expand its operations in a badly polluted area, thereby making pollution problems worse, only if it

can get another firm in the vicinity to reduce its pollution by a comparable amount.

As with taxes, marketable permits enhance flexibility, as each participant in the market is given the opportunity to weigh the value of obtaining or selling the permit versus the cost of abatement. One current barrier to the adoption of tradable permit schemes is that the details of how they could be implemented have rarely been worked out. The basic problem is to define the rights in a manner that is enforceable, that enables political decisionmakers to be sufficiently certain that the social goals of the policy can be attained, and that allows the establishment of a well-functioning market.

Among the least interventionist approaches to government policymaking for business is reliance on **unregulated markets policed by the law of contracts and torts.** Some have suggested that, in lieu of conventional regulation and particularly in areas of consumer product safety, tort law be adjusted to facilitate class action suits, to alter the burden of proof in cases involving alleged injuries, or to change the methods by which damages are calculated.

Lawsuits, however, are slow and expensive to pursue. Liberalizing the burden of proof may make undeserving parties—persons whose injuries were not caused by the party sued—eligible to collect damages. Furthermore, lawsuits serve primarily a compensatory function and rely on the incentives created by possible litigation to prevent injuries. Unless the legal system is quite efficient—the right cases are litigated and accurate damages awarded—the incentives created by the possibility of litigation may not lead firms to take the appropriate preventive measures.

Conclusion

After having carefully considered the various regulatory tools that are available, the Panel has concluded that the alternatives to command-and-control regulation should be used more widely. In particular, the Panel endorses the trend toward more extensive use of disclosure requirements in the area of economic regulation such as occupational licensing, and experimentation with taxes and marketable permits in some areas of environmental policy. The Panel also recognizes that there are no panaceas, that each option has its own set of problems, and that solutions which appear promising because of their simplicity often become complex as the regulator attempts to implement them. Moreover, the fact that one method is appropriate for one area of regulation does not mean that it will be effective in another area. Nonetheless, in the current political climate, it is necessary for those who wish to see society achieve its regulatory goals to examine other ways of reaching them and to experiment with alternatives on a limited

basis. To maintain an ideological rigidity by insisting that traditional ways are the only ones possible may result in a lowering of society's sights rather than in success in meeting present goals.*

*This report does not discuss the important matter of what sanctions are appropriate for violations of whatever requirements are established. The Panel concluded that the topic required a much more detailed treatment than it could provide, given limitations of time and resources.

Notes

1. For an extensive review of approaches to regulatory problems, see Stephen Breyer, "Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform," *Harvard Law Review*, Vol. 92, No. 3 (January 1979):549-609.
2. Ibid., p. 573.

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Chapter 4

Who Should Regulate?

- ☐ Legislation to enact a national no-fault automobile insurance program stalled in Congress during the second half of the 1970s, in part because of forceful objections by opponents that the states, rather than the federal government, should design and control this regulatory program.
- ☐ The city councils of Cambridge, Mass., Princeton, N.J., and other communities throughout the country are currently deciding the conditions under which recombinant DNA (gene-splicing) research can be conducted within their limits.
- ☐ Several states and Congress are grappling with very difficult questions concerning the hazards of nuclear and toxic chemical wastes. Not the least of the questions being debated is the relative roles of the federal, state, and local governments in determining where these highly dangerous materials will be stored, treated, or destroyed.

This chapter addresses a question common to these different situations—which level of government is best suited to carry out a particular regulatory program? This generic issue will probably become more urgent in the next 10 years as the roles of the federal and state governments are recast. Budgetary pressures, for one, will create a greater tendency for legislators at one level of government to look to the other levels of government to pay for and implement socially popular but expensive programs.

Institutional Impediments

Before examining the factors that ought to bear on a decision as to the appropriate level of government, it is important to recognize two constraints that prevent a purely "rational" solution from being reached. First, people seeking legislation that would create a new regulatory program

naturally are more concerned about the passage of the legislation than with who administers it. Thus, they will approach the legislative body that is most likely to respond favorably, even though that level of government may not have the best potential for efficient or equitable administration of the program.

At this point the second constraint comes into play. Under the Constitution, the federal government's ability to force a state to carry out a regulatory program is substantial, but not unlimited.* State legislatures are more restricted; they can never compel Congress or a federal agency to establish a new program, no matter how beneficial or efficient it might be to administer it nationally. The relationship of states to local governments (cities, towns, and counties) is generally somewhat more flexible than the federal-state relationship, since state legislatures usually have the authority to determine the rights and obligations of subordinate political units. Because of these two constraints, the legislature that decides whether to intervene may have a limited choice about which level of government should act.

Occasionally the debate about which level of government should regulate is used to prevent one level of government from intervening at all. At the federal level, for example, opponents of no-fault legislation have argued that the states could carry out the program more efficiently and that Congress therefore should leave the responsibility of passing the necessary legislation to them. This argument overlooks the fact that Congressional inaction does not automatically prompt states to act. Usually, Congress passes a law and tries to obtain state cooperation in administering the program where state administration clearly would be more efficient and fair.

Congress has several ways to encourage states to do what it cannot force them to do. A frequently used Congressional "carrot" is to provide federal funds to assist state implementation of programs. For example, the Environmental Protection Agency requires local municipalities to clean up the sewage discharged into streams and rivers. To encourage this, it makes available sizable grants to underwrite construction of municipal sewage treatment plants. A closely related "stick" is to cut off federal funds when a state refuses to follow federal policy. For instance, highway funds may be withheld from any state which does not enforce a 55 mph speed limit. Another "stick" is the threat of federal enforcement. For example, the EPA may establish and enforce rules governing air pollution in

*See, for example, *National League of Cities v. Usery*, 426 U.S. 833 (1976), a case in which a federal law extending minimum wage and maximum hour requirements to state employees was declared an unconstitutional interference with state sovereignty.

any state which does not establish its own EPA-approved air pollution control plan.

Determining the Roles of Federal and State Governments

Criteria. A legislator interested in determining whether the federal, state, or local government is best suited to perform a particular regulatory function should begin by considering at least three factors: (1) which level of government has the authority to control the conduct giving rise to a regulatory program; (2) which level provides affected groups a meaningful opportunity to participate in the decision-making; and (3) which level is likely to be most efficient in administering the program. Three other considerations are the experimental nature of programs, the need for national uniformity, and the problems of parochialism.

Scope of authority. The most obvious factor to consider in evaluating the desirability of state, local, or federal administration is the legal ability to deal with all aspects of a problem. Although many kinds of problems occur in many separate localities, they are often dealt with by each locality. Traffic regulation—a national phenomenon, but universally a function of local government—is the most familiar example. Other activities, such as pollution of a major river, have impacts both within and beyond the localities in which they occur. To regulate these effectively requires coordination of the laws of the different jurisdictions, which is often impossible to achieve, or action by a level of government that embraces all the localities.

Public participation. The second factor to consider is the degree to which different groups can participate meaningfully in the process of developing specific regulations once the legislation has been enacted. Generally, decision-making at a local level permits greater, more active citizen participation. For example, residents often express their views about proposed changes in land use to local zoning boards. Certain kinds of issues, however, attract more public involvement at the federal than at state or local levels. These issues usually involve highly technical matters. To discuss them effectively, one must understand how the issues are framed and be familiar with all of the relevant information. The costs of putting material together and of organizing for and participating in complex proceedings are high, placing groups with limited resources at a disadvantage, especially if an issue is being considered in several forums. Approaching an issue at the federal level is easier because fewer resources are needed than would be required to address the issue in 50 different states. Because more groups can afford to participate, the debates often are better balanced at the federal level.

Efficient government. Sometimes it is more efficient to administer a program at the state or local level; at other

times the federal government can perform the regulatory function most economically. Thus, the third factor to consider is which level of government can administer a program successfully at the least cost. When the implementation of a program should depend on local conditions, local government is likely to be more efficient because it is responsive to local needs. Moreover, state and local bureaucracies tend to be smaller than their federal counterparts and, hence, potentially capable of providing more timely responses. The reality, of course, varies from program to program and state to state, and indeed a local branch of a federal agency can have all the advantages of a state agency, plus potentially greater resources, if the national office is willing to give the local office sufficient independence.

Federal administration, on the other hand, is often particularly appropriate for issues involving highly complex social or scientific judgments, such as assessments of drug safety. Not only do a significant number of states lack the necessary expertise to make such decisions, but requiring separate decisions in 50 states could be duplicative and therefore wasteful.

Finally, in considering a new regulatory program, it is pertinent to ask whether the state or federal government already has an administrative structure that can assume the new responsibilities easily. For instance, enforcement of federal pesticide laws has been delegated to the states that have traditionally regulated the use of pesticides, which avoided the creation of a new body of federal enforcement officials.

Experimental programs. There is also a fourth factor that some cite as an argument against federal involvement—whether the regulatory program is experimental in nature. In the past, many have argued that the states can serve as "little laboratories" and are, therefore, better suited than the federal government to try innovative regulatory programs. If the experiment goes awry, there will be fewer harmful effects than if the experiment were national in scope. On the other hand, others argue that, although historically states have often led the way in developing new regulatory strategies, there is no legal or organizational necessity for continuing this arrangement. The federal government is equally capable of conducting experimental programs of limited scope if Congress provides for it. In fact, the federal government has recently been the source of more regulatory innovation than the states.

It has sometimes been politically difficult to gain acceptance for limited experimental programs at the federal level. Congress has a well-known tendency to generalize the particular. If an experimental intervention confers

material benefits (e.g. jobs, money) upon targeted constituencies, Congress may find it difficult to adopt the program without extending it to a larger number of states or districts than is appropriate. The Model Cities legislation is a good example. Congress originally envisioned it as a limited experiment directed at a handful of cities, but faced irresistible pressure to extend its benefits to many localities whose need was dubious. This phenomenon is not limited to traditional subsidy programs; an experiment in regulation could be similarly affected. For example, a constituency might not want to forego the anticipated benefits of a new pollution control strategy; remaining the baseline against which progress is measured will not appeal to many communities or their representatives, especially if lives or jobs are at stake. Thus, it may be easier to establish some experimental programs at the state level.

As with all generalizations, the applicability of the above factors has limitations. In two circumstances, it may be appropriate to assign responsibility for administering a program to the federal government rather than to the states, even though consideration of the factors may suggest that a local program would be better.

National uniformity. First, in some cases national uniformity is important. For instance, if there were differing state requirements concerning automobile safety or pollution equipment, it might lead to so many different vehicle designs that large-scale mass production of cars would be jeopardized. A closely-related concern is that certain fundamental rights of citizens, such as voting and equal employment opportunity, should not differ from state to state. To assure equality in these areas, the federal government must enforce the regulatory programs designed to protect these rights.

Parochialism. Second, federal administration is sometimes necessary to overcome the parochial interests of states. State control of pollution is an excellent example. Since some large and important industries may try to locate in states with the least stringent pollution standards, a state could be discouraged from regulating pollution vigorously if other states did not have standards at least as tough. Even if a state did choose to regulate some pollution, it would probably ignore downstream or downwind effects on neighboring states, since it would not benefit directly from additional controls.

One of the most important current regulatory topics, the siting of hazardous waste disposal facilities, demonstrates the problem of parochialism. There is increasing concern about how to dispose of various forms of hazardous wastes. Unlike control of pollution, where states vied for businesses by having the most permissive environmental regulations, they are now competing to establish the

toughest disposal standards, including, in some cases, outright prohibition of any dumping of hazardous wastes within their boundaries. Obviously, if this trend became sufficiently widespread, it could effectively shut down major chemical companies, for example. Thus, it may be necessary for certain places to be designated as disposal sites, and only the federal government can do that.

Shared responsibility. There is, of course, no reason why all the responsibility for a program must fall at either the federal or local level, instead of being shared between them. If such an allocation is to be made, each element of the program should be considered, using the relevant criteria. Generally, a regulatory program can be divided into several components: policymaking, enforcement, and financing. Policymaking is usually performed by a centralized decisionmaker in order to assure that a policy affects everyone equally. Not surprisingly then, when the federal and state governments share responsibility for administering a program, most policies are usually set at the federal level.

As a rule, the enforcement component of a regulatory program is most effective when decentralized. On a day-to-day basis, an administrative agency must make numerous decisions concerning the implementation of a policy. For example, if the regulatory program is built around prohibitions or restrictions, someone must choose which activities to monitor, decide whether a particular activity is a violation, and determine what sanction (if any) is appropriate. Initial decisions on these matters, or even detailed review by an office at a national headquarters, would be unmanageable. Decentralization of authority from the federal level can occur either by allowing the states to assume enforcement functions subject to federal supervision, or by creating regional federal offices responsible for carrying out a program.

Financing, too, can be shared. Some state-run programs are paid for in their entirety by the federal government; others are supported only partially by federal funds. Whatever the case, the availability of large sums of federal money and the fiscal belt-tightening of the last few years have made it exceedingly difficult for states to turn down federal dollars. Not surprisingly then, federal funds, primarily grants-in-aid, have accounted for an increasing share of state and local regulatory budgets in the last decade.

In deciding which, if any, regulatory functions the federal government should delegate to a state, it is important to remember the lessons of the 1960s and 1970s. A regulatory program that relies on substantial state funding or state enforcement of federally-created policies will usually fail unless the state agrees with the fundamental

goal of the program and does not regard itself as being coerced into using standards and enforcement methods it does not support. This is best exemplified by the resistance of most states to federal proposals that they establish programs to inspect automobile pollution control systems.

Even where states are willing to cooperate in the funding or administration of federal regulatory programs, it is still useful to consider whether the state will carry out the responsibilities more efficiently and fairly than the federal government. The factors discussed earlier in this section will serve as a useful guide in making this judgment. It is also necessary, however, to consider the problems that could be created by the sharing of administrative responsibilities. For example, when deciding whether the federal government should bear all or only part of the burden of paying for a regulatory program, it is important to look at the extent to which the states would be able to absorb additional fiscal responsibilities. To the degree they could not, the imposition of additional burdens could lead to a deterioration in the quality of the other services provided by the states and a greater tendency to seek further fiscal support from the federal government. In addition, the existence of federal programs may cause changes in the design of related state programs or necessitate the creation of additional administrative structures at the federal level to induce state compliance. Finally, accountability is made more difficult when two levels of government share responsibility for a program.

In summary, the question of which level of government is best suited to administer a regulatory program is often not considered carefully enough when legislatures establish new regulatory programs or consider changes to improve the efficiency of existing ones. Nonetheless, the choice can have important effects on the success with which a program is carried out and therefore warrants more thoughtful attention than it now receives.

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Chapter 5

Acting IN THE Face OF Uncertainty

The Food and Drug Administration (FDA) has just received the results of a test in which one group of rats and mice was given large doses of an ingredient being added to many foods, while a second group of control animals was fed normally. Otherwise the two groups were treated alike. Because the study shows a 25 percent greater rate of tumors in the test group, the FDA must decide whether to ban the substance or control its use in some way.

The Commissioner of the FDA feels the need to take some action, but is troubled by a number of questions. The Delaney Clause contained in the Federal Food, Drug, and Cosmetic Act requires him to prohibit the addition to food of any substance which causes cancer in animals. Yet even that seemingly clear mandate may not apply. How confident must the FDA be in the study? Were the tests properly conducted? Is the 25 percent differential sufficient, in light of the number of animals tested, to establish the necessary causal connection? If the Commissioner cannot reach a definitive conclusion, should he err on the side of safety and issue the ban, do nothing, or do something in between, such as require warning labels? These questions illustrate the considerable uncertainty that surrounds many regulatory problems. Once a decision has been made to intervene, regulators often find that the information available to them does not lead to clearcut regulatory actions. This chapter examines the problems of uncertainty in regulatory decisionmaking processes and discusses approaches to help solve them.

The Role of Legislatures

Although much of the current discussion of uncertainty concerns the difficulty faced by the regulator, initially it is the legislature which must address the matter. The Congress, in adopting the Delaney Clause, thought it had resolved the issue of uncertainty in favor of prohibiting the addition of animal carcinogens to the human food supply, but they had not because the carcinogenicity of a substance is often in doubt. In many other cases, the decisions are

even more difficult because the legislative guidelines are even less clear. For example, what is the proper response where the risks of harm of a chemical commonly used in the workplace are uncertain, both in terms of the likelihood and magnitude of potential harm, where the estimated costs of protecting workers or finding a substitute chemical are widely divergent, and where the industry contends that it will be placed at a serious competitive disadvantage with imports if forced to adopt the proposed measures?

Legislators are faced with another set of choices in which there is uncertainty: is a program really needed, and if so, how should it be designed when the problem is ill-defined and much of the data lacking? For example, should Congress mandate that only federal agencies may impose controls on recombinant DNA research and prohibit local governments, which are concerned about escaping bacteria, from regulating ongoing research? In such a situation, doing nothing is not a neutral stance, since it allows both industry and localities to proceed, perhaps on a collision course. How certain should Congress be before acting, and are there any guidelines that can assist conscientious legislators in carrying out their duties?

Increasingly, it is apparent that decisionmakers cannot assume that these issues can be resolved by facts. In part this is because the facts themselves are often in doubt. As an example, it is a fact that certain chemicals cause cancer in rats. It is usually a hypothesis that they will also cause cancer in humans. When the facts are in doubt, resolution of the issue depends on a political judgment about the appropriate way to act under conditions of uncertainty that blends the information on known costs and risks with less complete information on other aspects of the problem.

It is the Panel's view that facts are often assumed to play too decisive a role and that legislators are too prone to believe that decisions can be made based upon the agreed-upon analysis of experts.* Because consensus among experts is unlikely, it may be that legislatures rather than experts must provide guidance about the course of action a regulator should follow when confronted by uncertainty. Questions about matters such as the definition of acceptable risk are inherently political, and regulators cannot be expected to resolve them through expert analysis and quasi-judicial, evidentiary proceedings.

The inevitable response to uncertainty is a cry for more research to produce more information. In order to assess the validity of that call, it is necessary to recognize that there are two kinds of uncertainty with rather

*The report of the Panel on Science and Technology: Promises and Dangers discusses the role of expert scientific opinion in the formulation of public policy.

different consequences in terms of the usefulness of seeking more definitive knowledge. Certain problems can be clarified by further research. For instance, when questions arise about the effectiveness of a particular device in removing pollution, it may be possible to gain further insight through more tests. Other problems, however, simply are not amenable to timely answers through further research. For example, some people claim that current scientific experimentation with recombinant DNA will accelerate the discovery of a cure for cancer. At the same time, others fear that recombinant DNA research could accidentally produce a super-virus. Both possibilities are pertinent to any argument about regulating recombinant DNA research, but neither a breakthrough nor a tragedy is inevitable. More importantly, one can only discover whether either possibility will come true by allowing recombinant DNA research to proceed; a limited test cannot provide the answer. This example involves doubts about the magnitude of the risks and benefits of an activity, but the same kinds of irresolvable questions also arise in other regulatory contexts such as, for example, the costs or effectiveness of controls on emissions of oxides of nitrogen on ambient air quality or the effects of different pricing rules for electric utilities on their rate of innovation.

Because some problems are inherently bedeviled by uncertainty and no amount of research can remove all doubts, legislatures have passed statutes such as the Occupational Safety and Health Act that simply require the regulator to use "the best available evidence" in reaching what is the most reasonable solution under the circumstances. While this recognizes the inherent uncertainties faced by an agency, it hardly resolves the difficulty. It does not tell the agency how to cope with uncertainty in its decisionmaking, in particular, how much uncertainty to tolerate overall or with respect to specific aspects of a problem, such as compliance costs, health effects, the effectiveness of technological solutions, or the ease with which a consumer can avoid the risk.

One of the most controversial issues in regulatory policy is how regulators should act in the face of uncertainty. For example, how much evidence about the health effects of a chemical is needed to justify a ban on its use in consumer products or a stiff standard against exposing workers to it? Does the answer depend on the economic dislocation that a ban would cause? Should regulators be significantly more willing to establish stringent regulations if the people being exposed are children rather than adults, or workers rather than consumers? The answers to all of these questions involve value judgments about which people can legitimately disagree. Such conflicts of values require political resolution, and not simply a fact-finding

investigation. Yet Congress has been reluctant to address them in writing regulatory legislation. While a reluctance to provide guidance on these questions is understandable because of the unavoidably controversial nature of such issues, the Panel believes that rational policy requires that legislators provide greater leadership in resolving them.

In making these determinations, several factors ought to be considered. Principal among these is an assessment of both the magnitude of the harm that is likely to arise if no action is taken and the likelihood that the harm will occur. Other important issues include **reversibility** (the extent to which harm can be undone) and **avoidability** (referring to whether people assume the risk involuntarily or as a matter of choice). For example, the hazards of cigarettes to smokers may call for a different policy than the effects of smoking on non-smokers.

In addition, it is useful to see if the kind of harm to be prevented is one ordinarily associated with the activity involved. Thus, for example, laws designed to prevent companies from going bankrupt ought not to be enacted since that risk (as well as the chance to succeed) is a normal element of the free enterprise system that does not require government protection. For this reason, as well as for several of those cited above, the Panel believes that issues of uncertainty in the area of economic regulation should generally be resolved against regulation, or at least in favor of disclosure as opposed to outright prohibitions or detailed price and profit controls. On the other hand, where health issues are at stake, and many of the harms cannot be corrected, the balance is likely to be rather different.

The Role of Regulators

When faced with uncertainty about a product or activity, regulators should consider the full range of regulatory approaches authorized by statute. Intermediate techniques, rather than an all-or-nothing approach, may be appropriate. Disclosure, for example, may have considerably less harsh consequences than a total prohibition or no action. Thus, if the evidence is inconclusive as to the effect of chemicals in the workplace, the government should at least require that companies tell their employees what they are handling so that they can make more informed decisions about their work environment and, perhaps through their representatives, bargain to have some of the chemicals eliminated and have better protection against others. Similarly, in the area of occupational licensing, the harm to the public from retaining lay persons instead of divorce lawyers is unproven, especially where little money and no children are involved. Thus, requiring disclosure of qualifications or lack of them should serve the public just as well as an absolute prohibition on lay assistance. Warnings

rather than prohibitions are an approach which is particularly appropriate where the harm can be avoided. Government has opted for this approach with cigarettes, where there is little doubt as to the harmful health effects. While there are obvious limitations to the applicability of this strategy—people can avoid smoking but not breathing—it is an avenue that the Panel recommends for further exploration where either uncertainty or other factors counsel against the approaches of standard-setting or outright prohibition.

The Panel also acknowledges that, in some instances, there may be incentives for regulators to do nothing or, in other cases, to do something—anything—even though sound policy would not dictate such action. Regulators often fear, not without justification, that their decisions will be second-guessed, and this fear distorts their decision-making. While not all regulators are significantly influenced by the possibility of hostile public reaction to their decisions, some students of the regulatory system attribute some of its problems to the desire of decisionmakers to minimize unpopular and highly visible decisions. Many regulators realize they have limited political goodwill to use in carrying out their long-term policy objectives and thus want to avoid the kinds of catastrophic consequences which quickly come to the attention of Congress or the President, such as forcing a national firm into bankruptcy or causing widespread death by illness through a failure to act. If the cost of avoiding such a remote possibility is imposing a little extra cost or creating less competition, regulators have an incentive to do so.

Regulation of public utilities provides an instructive example. Those who decide what rates electric and gas companies may charge are aware that the price of a service is usually the most visible and most important consequence of their activities. One scholar asserts that, for this reason, a regulator's primary concern in setting public utility rates is to keep price increases as low as possible, rather than to regulate the rate of return or to pursue some other regulatory goal.[1] The only exception is that a prolonged blackout of electrical power or a system-wide cutoff of gas would provoke even greater public criticism than higher rates. Therefore, some regulators tend to authorize utilities to build systems with greater capacity than necessary, thus driving up overall costs for customers. While the Panel does not suggest that regulators should ignore potential public reaction to their proposals, it does believe that there is a need for greater public recognition of the inevitability of uncertainty and the lack of usefulness of second-guessing decisions that had to be made on the basis of necessarily imperfect information.

There is another important constraint on regulatory action in the face of uncertainty—the possibility of court review of an agency's determinations. If a regulator cannot point to evidence sufficient to support his decision, the courts may overturn it, as in the 1980 Supreme Court decision on the Occupational Safety and Health Administration's benzene rule. The potential for court reversal sometimes induces regulators to collect more information than is needed before acting, thereby biasing the regulatory process toward delay, both in initial actions and subsequently in revising previous decisions. The Panel believes that a better definition of what is inadequate or excessive information is needed to guide decisionmakers. Two positive developments would be fuller public discussion of issues, along with more adequate policy guidance from the legislatures.

Procedural Rules and Uncertainty

The Panel has observed that the application of procedural rules often obscures the real issues involved in deciding what course of conduct to take in the face of uncertainty. These procedures include burdens of proof at the agency level and standards of review in the courts once the agency has acted. The Panel believes that although the concept of burden of proof is useful in dealing with situations involving uncertainty, it is insufficient by itself. A burden of proof simply announces that in the face of uncertainty, one side or the other is presumed to be correct, with action or inaction following accordingly. Thus, whoever is assigned the burden of proof in effect is assigned the burden of uncertainty and given the task of showing that his position is correct. That task is precisely the kind of value judgment that legislatures should be making where there is uncertainty. Similarly, the standards of court review, which are deferential to regulatory agencies, are based on the assumption that when an agency has been charged with a regulatory responsibility, the burden of demonstrating error (i.e., that the agency was almost certainly wrong in doing what it did) falls on the party seeking to overturn the decision. This amounts to a backhanded way of resolving the question of uncertainty. Therefore, the Panel urges the legislatures and the courts to recognize that, in the area of uncertainty, procedural rules are, in fact, being used to make substantive determinations of policy as to how government should act when everything cannot be known in advance.

As with other issues discussed in this report, there are no simple answers, only the opportunity and need for more intelligent analysis. Uncertainty is an unavoidable element in most regulatory decisions—an element that has a significant impact on the behavior of decisionmakers. To deal

with it effectively, both regulators and political leaders need to be more forthright in their discussions of issues, and legislators need to provide more guidance to administrative officials about how to make decisions in circumstances of unavoidable uncertainty. Most importantly, means must be developed within regulatory law to make regulatory policy more flexible and bring it more in line with the informational realities facing regulators.

Finally, the Panel believes that it is necessary to emphasize that a decision not to regulate is in fact a decision to do something. Presumably, the call for regulation arises because some problem exists, and failure to act does nothing to alleviate it. This is not to say, of course, that every alleged problem requires an immediate solution. But, whether wise or not, a decision not to act is hardly neutral.

Note

1. Paul L. Joskow, "Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation," *Journal of Law and Economics,* Vol. 17 (October 1974):296-299.

PART B

Analyses of Current Regulatory Issues

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Chapter 6

Procedural Reform

Every regulatory program embodies numerous procedures that guide both officials and the public on how the regulatory process is to be conducted. These procedures cover a wide range of nuts and bolts matters within a context of political values that may be inherently difficult to reconcile. As one scholar notes, governmental processes are expected to safeguard accountability, equity, efficiency, and responsiveness—all the while preserving fiscal integrity.[1] Another describes a successful regulatory process in terms of public satisfaction, efficiency, and fairness, emphasizing the necessary tradeoffs among them.[2] To the extent that decisionmakers take into account the views of all interested parties and all demonstrable social and economic impacts, the price will be delay and other costs. On the other hand, efficient procedures may not necessarily satisfy the citizenry. A proper balance among these objectives is an elusive, but prized, goal.

Any serious assessment of government regulation requires some attention to procedures for several reasons. First, procedures are a major focus of the current debate about regulation. In particular, much of the blame for the ineffectiveness of regulation is attributed to inappropriate procedures. In fact, procedural mechanisms are frequently complicated, often contradictory, and cumbersome; they consume substantial public and private resources and can cause lengthy delays. Not surprisingly, they have generated considerable frustration.

Second, procedures frequently end up defining and resolving regulatory issues, a phenomenon discussed further below. The Panel hopes that in the future more substantive disagreements can be resolved without being recast in procedural terms. The Panel itself has reservations about the usefulness of procedural reform precisely because the real issues, the crux of reform, are too often cast as procedural ones and therefore go unaddressed.

Because of the importance of procedures, the role that they have come to play in the achievement of regulatory objectives, and the attention they are receiving as an issue

of reform, the Panel opens its discussion of future trends in regulation with a review of procedures and their place in the regulatory process.

History of Procedural Reform

Since 1941, when the Attorney General's Committee on Administrative Procedure recommended more informal agency hearings and the decentralization of agency decisionmaking away from commission members, there have been numerous proposals for procedural reform.[3] Given the variety of regulatory problems and the different perspectives from which regulation is viewed, the proposals range widely (and somewhat inconsistently) in both the illnesses they seek to treat and the solutions they prescribe.

The desire for reform fostered the Administrative Procedure Act (APA) of 1946, which is still the statutory centerpiece of the federal regulatory process. Significantly, the APA sprang in part from

> those who felt that existing procedures simply were inadequate for handling [new areas of regulation], and from those who opposed the New Deal programs in substance but were unable to attack them directly [because of their general popularity].[4]

The APA was an attempt to remedy these and other problems by setting forth the conditions for adjudicating specific disputes and issuing broad, substantive rules.

Dissatisfaction with the APA mechanisms has grown over the years. Recently one scholar noted that "[m]any see the APA as being overjudicialized, too rigid in its approach, and irrelevant or incomplete in its solutions."[5] A study prepared for the Senate in 1977-78 recommended that the APA be amended to allow agencies to move away from formal adjudicatory procedures and toward greater use of informal rulemaking. It also recommended that the APA require agencies to speed decisionmaking by establishing deadlines for proceedings wherever possible. Likewise, both the American Bar Association and the House Committee on Oversight and Investigation (the Moss Committee) endorsed less agency reliance on formal procedures.[6]

Current Proposals for Reform

Although the debate is often couched in different terms, the central issue in procedural reform is the distribution of power to affect decisions. Procedures, because they assign roles to various interest groups or institutions in the setting and implementing of policy, determine the relative influence of the parties affected by regulation. A group that obtains a predominant role in decisionmaking will, in large part, define an issue, particularly where other interests are poorly articulated or diffuse. As such, that group will also

set the course a regulatory issue will follow. Hence procedural reform allocates political power.

Viewed in terms of the allocation of political power, current proposals for procedural reform can be grouped into four categories, depending upon whether they: (1) give more power to elected officials, particularly the President or Congress; (2) enhance the role of the courts; (3) provide greater opportunity for participation by more groups; or (4) leave substantial responsibility with the agency but change the methods by which it gathers and evaluates the information on which it will base its decisions.

Reforms in the first category are put forward in the belief that inertia, waste, and unnecessary burdens result from inadequate Congressional or Presidential oversight of regulation. Accordingly, the following have been suggested:

- ☐ *Legislative veto*—Congress, or a part of it, could veto an agency regulation before it took effect.
- ☐ *Sunset laws*—Agencies or programs would expire automatically unless extended by new legislation.
- ☐ *"High noon" review*—A Presidentially-appointed committee would review selected agencies over a 10-year period. The committee would make recommendations to the President for inclusion in a regular report to Congress on continuing certain programs.
- ☐ *Regulatory budget*—Annually the executive branch would prepare a budget for the maximum cost to the country for complying with each agency's regulations and for all regulations. These would be submitted to Congress, which would then legislate the next year's maximum budget for compliance.
- ☐ *Increased Presidential authority to review (or reverse) agency decisions.*

Those wishing greater involvement by the courts have suggested modifications of two concepts long-established in administrative law—the burden of proof and the presumption of validity. The "Bumpers Amendment," currently before Congress, would effect these changes. Although the proposals vary, all call for greater judicial scrutiny over legal issues and the degree to which an agency has provided adequate evidence to support its positions. In effect, the court would be allowed, indeed directed, to substitute its judgment for that of the agency much more fully than has been done in the past. Judicial review of an agency's analysis of the impacts of its regulations has also been proposed. It should be noted that the outcome under any of these proposals will depend to a large extent on the

views presented. That is, outcomes will be tied to those groups presenting testimony.

A belief that citizens do not have enough say in government decisions has resulted in calls for greater public participation. One proposal is for greater public input in appointments to federal agencies. Another is that subsidies be provided to "public interest" groups so that they can participate in agency proceedings. In this way, a broader spectrum of opinion will be available to decisionmakers, enhancing the likelihood of a more widely acceptable decision. Such programs now exist at the Federal Trade Commission and the Consumer Product Safety Commission.

Another group of proposals calls for greater use of non-adversarial means of resolving disputes. Rather than relying on court litigation or formal agency hearings to decide regulatory issues, some people advocate that the interested parties be encouraged to work their differences out privately. A number of alternatives to the formal adversarial process have been proposed: environmental mediation, voluntary standard-setting by industry trade associations, and arbitration of consumer disputes.* These proposals draw heavily on the long and successful experience with arbitration in the labor-management area.

Finally, persons critical of "red tape" and administrative delay, anxious to promote agency aggressiveness, or fearful of decisions based on inadequate information have offered numerous proposals. These include reforms to reduce the volume of paperwork required to comply with agency regulations, increased use of rulemaking, broader powers of subpoena, and more systematic and mandatory analysis of the costs and benefits of regulations with respect to both the area being regulated and national socioeconomic conditions as a whole.

Somewhat akin to the proposals for procedural reform are those for structural reform. They are provoked by the same frustrations and concerns and are seen by some as relatively quick and easy solutions to the problems with regulation. As with procedural reforms, they tend to hide the real issues. Because they, too, will be an issue in the 1980s, they are discussed here briefly.

Proposals for structural reform must be treated with caution. There have been repeated calls, for example, that independent regulatory commissions be placed within the departments of the executive branch (to enhance accountability), that multi-member commissions be abolished in favor of agencies with a single head (to reduce delay), and that agencies be grouped more functionally (to eliminate

* The report of the Panel on the Electoral and Democratic Process discusses the growing need for and use of alternatives to the judicial system for resolving disputes.

overlap and improve coordination). Like those who support procedural reforms, advocates of these proposals tend to defend them in apolitical, nonpartisan, efficiency terms.

Proposals such as these are advanced at strikingly regular intervals. Each decade sees some prestigious group (e.g. the Brownlow Commission in the 1930s, the Ash Council in the 1970s) recommend major overhauls of executive branch structure. Even more frequently, individual agencies are reconstituted or shifted. For example, the Federal Power Commission was recently transferred to the Department of Energy. Because regulatory authority within a single sphere is often divided among two or more bureaucracies—for example, the futures markets for agricultural commodities are regulated by an independent commission, whereas the spot markets for the same commodities are regulated within the Department of Agriculture—reorganization appears to make sense to achieve greater policy coordination and the elimination of "red tape." While subtle improvements in policy may result from such structural decisions, the effects have not been such that the reforms deserve widespread replication. As with some of its procedural counterparts, structural reform often ignores the thorniest problems—those stemming from the nature of each regulatory task, its intrinsic uncertainty, or its adverse impact upon particular interests in society.

Prospects for Success

There is undoubtedly merit in some of the proposed reforms. The problems they address are real. Nevertheless, they have substantive consequences in terms of costs and power that require caution and close scrutiny. They should not be pushed as panaceas for the regulatory problem. That "problem" is actually many different problems that defy easy, quick, or painless solutions.

The history of procedural and structural reform is both rich and unpromising. Roughly once a decade since the 1930s, significant changes have been proposed for the structure and procedures of regulatory agencies, and many have been adopted. Very soon thereafter, complaints about expense, slowness, and arbitrariness reemerged. This happens because the fundamental causes of procedural inefficency and the likely effects of reforms are not analyzed realistically.

The proposals for greater involvement by the courts are a good example. The judiciary is a convenient arena for contesting the correctness of an agency's procedures, the data supporting its conclusions, and the statutory legitimacy of its ends. However, the courts are now less inclined to review agency activities with the intent of imposing additional procedural requirements not mandated by a

statute. Current proposals involving the courts focus on greater judicial review of the merits of agency decisions.

Although an expanded role for the courts may be desirable, it would mean shifting more decisionmaking power to the least accountable segment of the government and the one that generally lacks expertise in technical areas. Furthermore, a more stringent standard of review could trigger a corresponding, defensive shift in the decisionmaking criteria used by regulatory agencies and a greater reluctance to act. Some critics argue that these reforms could cause the regulatory system to come to a virtual halt, with policy being made primarily in the courts.

There are no panaceas, no philosopher's stone that will turn all leaden procedures into golden tools for good government. The regulatory programs that embody them are too varied and complicated. As Ernest Gellhorn has written,

> The underlying problem with the proposals is that they have all proceeded as if the current regulatory malaise has one single cause. But the problems of the administrative process are many; most are peculiar to a specific agency or subject. Even where general principles or common threads seem identifiable, their application will vary and they must be tailored to the particular problems at hand.[7]

The dilemmas of procedural reform are well-illustrated by the National Environmental Policy Act (NEPA). It is almost certainly the most far-reaching of the statutes that addresses the procedures for agency analysis of the impact of regulation. Its principal enforcement mechanism is the environmental impact statement. The provisions of the act, along with the impact statement, were envisioned as the means to compel agencies to consider the environmental consequences of major government projects and programs.

NEPA has been a mixed blessing. Undoubtedly, it has raised the environmental consciousness of planners inside and outside the government. It has given private citizens concerned about environmental issues a vital tool with which to confront government and large corporations. However, the NEPA process is costly and time-consuming. Some observers argue that NEPA tends to institutionalize pessimism by encouraging undue consideration of unlikely "worst-case" scenarios. Others claim that environmental impact statements often are little more than self-congratulatory advertising by agencies. In some cases, administrators have become reluctant to set priorities among the issues to be investigated and spend undue time on less critical points, fearful that they will be accused of having provided insufficient evidence for their decisions.[8] Further, as with all regulation, NEPA, to be truly effective, requires

information that simply may not be available; it, too, must contend with the ever-present problem of uncertainty.*

It is doubtful that a single set of procedural principles, even if coherent and easy to follow, could resolve the problems of regulation. There is no science of administrative reform. Regulatory malaise may stem from using inappropriate means for achieving the objectives of regulation or from the uncertainty and complexity intrinsic in a particular area of regulation. If the latter is the case, procedural reform will only hide the real problems. Perhaps the most that can be hoped for is to use past mistakes to improve procedures and, in turn, reduce the problems of regulation.

*The Fishery Conservation and Management Act (FCMA)—the so-called "two-hundred-mile limit" law—also exemplifies some of these problems. Its implementation, particularly in New England, has been fraught with difficulties, some of which relate to the time-consuming procedural web in which it is entangled. The FCMA created Regional Fishery Management Councils, composed mostly of industry representatives and state government officials. These councils share with the Department of Commerce the responsibility for fishery management in the federally-administered waters adjacent to their respective regions. The representative nature of the councils may safeguard accountability and responsiveness, but at a cost—the formulation and implementation of plans under joint council-DOC aegis is time-consuming. Procedural reform might improve matters, but tough decisions will still have to be made—in the face of uncertainty.

Notes

1. James Q. Wilson, "The Bureaucracy Problem," *The Public Interest,* No. 6 (Winter 1967):3-9.
2. Paul Verkuil, "The Emerging Concept of Administrative Procedure," *Columbia Law Review,* Vol. 78 (1978):258.
3. American Enterprise Institute, *Government Regulation: Proposals for Procedural Reform,* Legislative Analysis Series, Washington, D.C., October 1979, p. 3.
4. U.S. Senate, Committee on Governmental Affairs, Subcommittee on Federal Regulation, 95th Congress, Second Session, *Study on Federal Regulation,* "Delay in the Regulatory Process," Vol. IV, Washington, D.C.: U.S. Government Printing Office, 1977.
5. Op. cit., Verkuil, p. 311.
6. American Bar Association, Commission on Law and the Economy, *Federal Regulation: Roads to Reform,* Washington, D.C., 1979; and "Federal Regulation and Regulatory Reform: Excerpts from the Moss Committee Report," *Administrative Law Review,* Vol. 29, No. 3 (Summer 1977):419-446.
7. Ernest Gellhorn, "Reform as Totem—A Skeptical View," *Regulation* (May/June 1979):23.
8. Eugene Bardach and Lucian Pugliaresi, "The Environmental-Impact Statement vs. the Real World," *The Public Interest,* No. 49 (Fall 1977):27-33.

Chapter 7

Trends IN Economic Regulation

Economic regulation—the control of prices, profits, and entry into the marketplace—is now abating in the United States. Broadly defined, this trend, known as economic deregulation, means less government control and more reliance on market forces such as competition. This chapter analyzes the trends and prospects in several industries in which substantial deregulation is or may soon be taking place: airlines, railroads, trucking, telecommunications, insurance, energy, financial institutions, and health care. Because the patterns of change have varied among the different industries, each is discussed separately.

The Airlines: The Forerunner

The airline industry led the way in deregulation, just as railroads led the way toward regulation a century ago. Economic regulation of the airline industry began in 1938, when the Civil Aeronautics Authority (later the Civil Aeronautics Board) was created. It was set up in the wake of financial problems within the industry, a series of scandals over the methods used by government to subsidize air mail, and a series of disasters (including a crash that killed a U.S. Senator) that raised the issue of safety. The industry supported regulation, because it wanted protection from the "destructive" impact of competition. It argued that controls were needed to preserve existing firms, to generate funds for improved safety, and to foster stability so that service could be expanded.

There are some who claim that even in the 1930s, this rationale was dubious and that the industry's problems were a result of the Great Depression. To support this viewpoint, they note that the costs of entry into the airline and trucking industries, where the rationale has been used most widely, have always been relatively low (in comparison with the railroad industry, for example). Further, capital has been highly liquid, that is, it can be sold easily. Both conditions make these industries especially well-suited to open competition. In any case, by the 1970s the airline industry had reached the point where establishment

of a monopoly or the possibility of widespread financial crises were unlikely. Hence the rationale for regulation had largely disappeared.

Deregulation first occurred with respect to cargo shipments. A law passed in late 1977 re-established competitive entry into the domestic cargo business by stating that a firm no longer had to show at a hearing that it was financially sound and qualified to provide service. In addition, the law ended the authority of the Civil Aeronautics Board (referred to as the CAB or Board) to control cargo rates.

Although the effects of cargo deregulation have not been dramatic, some important changes have occurred. Several firms have entered the scheduled all-cargo field; a few have started charter cargo operations. Cargo as an adjunct to passenger service has declined because customers have opted for the somewhat more expensive, but faster, all-cargo service. Total air cargo shipments have grown more rapidly than they did before deregulation. Rates have increased substantially, and only partially as a result of increased fuel costs. These facts suggest that regulation was preventing innovations that, while more costly, were preferred by shippers.

Deregulation of domestic passenger service began in 1978 and had more profound effects. The Airline Deregulation Act of that year ratified earlier CAB actions that had made entry easier and established greater flexibility in fares through a "zone of reasonableness" policy under which an airline can, without approval of the CAB, alter its rate within a range (zone) set by the agency. It also provided for a phased reduction in the Board's authority, with the agency to go out of existence on January 1, 1985.

Deregulation has resulted in the entry of several new airlines into scheduled, interstate service; an overall increase in the number of flights; reductions in fares on competitive routes; and, more generally, fare increases that have been less than the increases in operating costs in the same period. Deregulation has also increased industry interest in mergers. Airlines with excess capacity have sought alliances with airlines having especially profitable route structures; other airlines have sought mergers to rationalize the inefficient route structures that emerged during regulation. Finally, some controversy has resulted where service has deteriorated in some small communities, usually because of a shift from major carriers to local carriers using smaller planes.

The CAB had also begun to promote competition in the international market. In 1979 Congress passed legislation confirming most of the Board's general policies. As a result of deregulation, the U.S. government has been trying to negotiate liberal bilateral agreements covering international competition for both routes and rates,

while the Board has been trying to eliminate, or at least greatly restrict, the historic ratemaking role of the International Air Transport Association, a multinational price-setting cartel.

Although the Board may go out of existence as it is scheduled to do during the mid-1980s, some regulation will remain. All the Board's international functions, along with regulatory oversight of some activities, will continue within various executive branch departments (Transportation, State, and Justice). Finally, regardless of the course of economic deregulation in the airline industry, interest in airline safety regulation will persist, as will the issue of air passenger service to small communities.

Airline deregulation has proved to be the forerunner of deregulation throughout the transportation sector, as well as in other industries. It has generally been considered a success, even though the effects of more competition have been blurred by double-digit inflation and greatly increased fuel costs.

The Railroads: Industry Restructuring

Railroads were first regulated by the federal government under the Interstate Commerce Act of 1887. Before that time, the practice had been for railroads to use a discriminatory pricing system. Long-haul shipping between major cities (usually manufactured goods) was priced competitively because shippers normally could choose among railroads, while shipments (especially of agricultural crops) to and from small towns were priced monopolistically, since farmers usually had access to only one railroad. To compensate for the elimination of price discrimination, the government permitted regional ratesetting agreements, subject to approval by the Interstate Commerce Commission (ICC). This kept the price competition on long-haul shipping in line with the collective ratemaking being supervised by the ICC. By the 1920s, virtually every aspect of railroad operations, including entry, mergers, financing, and arrangements on the sharing of boxcars, was regulated.

Although deregulating the railroads was proposed as early as 1955, significant steps were not taken until after the failures of railroads in the northeast, capped by the bankruptcy of Penn Central and the promise of the same happening in the midwest, as signalled by the reorganization of the Rock Island in 1975. The financial difficulties of the railroads were in part a consequence of regulatory policies. The ICC had inhibited innovations such as the unit train, containerized shipping, and the Big John hopper car. The agency had also prevented railroads from dropping routes that, because of changes in the nature of the commodities being transported and the growth of trucking, were no longer viable. Finally, reflecting its historical

roots, the ICC continued to support low rates for shipments to and from rural communities, hoping the railroads could make up for the loss by charging higher rates for manufactured products shipped between cities. However, trucking took over an increasing share of the latter routes, and railroads were confronted with a shrinking source of revenue with which to offset losses elsewhere.

By the 1970s, it became apparent that fundamental changes had to be made. One possibility was government ownership—historically unpopular in the United States, although accepted elsewhere in the world. Nationalization of failing railroads was averted by passage of the Regional Rail Reorganization Act of 1973. Designed to rescue the essential rail services of Penn Central and other failing companies in the northeast, it called for the creation of Conrail (with federal financial assistance), an amalgam of several parallel eastern lines.

Conrail will perhaps be remembered as the high-water mark of the era of anti-competitive policies in railroading. It is the extreme example of regional consolidation. Conrail continues to have financial problems, and the ultimate solution is probably to separate the system into a few coherent, parallel lines operated by private companies. Such an approach, assisted by federal legislation, is being pursued with respect to failing railroads in the midwest.

Railroad deregulation began with the passage of the Railroad Revitalization and Regulatory Reform Act ("4-R Act") in 1975. It introduced the concept of "market dominance" as a key to making decisions regarding rates. The idea was to distinguish between non-competitive and competitive traffic and to regulate rates only for non-competitive service.

The ICC has made major changes in its approach to the regulation of the maximum rates for non-competitive traffic. The appropriateness of setting different prices on different routes has been recognized (leading to controversy with respect to several commodities, such as coal, which are now bearing higher rates), and proposals are being considered to create a "no-suspend, no-investigate" zone, within which rates could be freely adjusted. The Commission has also attempted to stimulate innovative pricing and service by reversing its long-standing policy of prohibiting contract rates (rates that are guaranteed by contract for a certain period).

ICC policy on route abandonment has also changed. The regulatory process has been sped up, and the Commission has indicated it is more receptive to dropping unprofitable lines. On routes where continuation of unprofitable service is required, provisions have been made for subsidies. Finally, the Commission has begun to exempt some railroad services from regulation. The first significant one—

transport of fresh fruits and vegetables—has resulted in a dramatic upsurge in the railroads' share of the market. The Commission has recently exempted other agricultural commodities and is considering still more.

Railroads have recently put forward an increasing number of proposals for mergers. Already approved is one between the Burlington Northern and Frisco, which will link two systems between the northwest and the southeast end-to-end, for a combined 27,000 mile network. Another more recently approved end-to-end merger will link the Chessie System with the Seaboard Coast Line (Family Lines); the new company will serve 22 states, the District of Columbia, and Ontario, Canada. Public announcements have been made of proposed mergers—between the Union Pacific and Missouri Pacific and between the Southern and N & W.

Additional mergers will undoubtedly be proposed. Government policy is likely to emphasize end-to-end mergers, which offer greater service advantages and have fewer anti-competitive consequences than parallel mergers. Ultimately, the more than 60 separate railroad systems currently operating across the country may be replaced by a few competitive transcontinental systems.

Further deregulation of the railroads is currently underway. Freedom to set rates will probably be granted for many more commodities, with the test of the need for regulation becoming whether competition of any form, including from other modes of transportation, is adequate to protect shippers from monopolistic abuses.

Unlike the CAB, the ICC is likely to exist indefinitely. It will play a regulatory role in determining whether consolidated routes are anti-competitive, in overseeing car service compensation, and in reviewing proposals for merger and route abandonment. However, its role should be substantially smaller than in the past, and in a few years most rail service may not be regulated.

The Trucking Industry: Increasing Competition

Trucking, in contrast to the railroads, was still an infant industry when it was brought under ICC regulation in 1935. As noted earlier, the primary rationale for the original Motor Carrier Act—the avoidance of destructive competition—was inspired by the Depression. The focus since has been primarily on such matters as limiting entry, defining areas of authorized service, and setting rates.

The present movement to reduce regulation of trucking has arisen, at least in part, from the inefficiencies created by the Byzantine nature of regulation in the industry. The ICC required that it approve every commodity shipped between a pair of cities in either direction. Often the ICC would grant a company a route for some commodities in one direction, but not in the other, meaning

that trucks had to return empty. Sometimes the ICC's decision was justified by traffic imbalances, sometimes not. In addition, in earlier periods the ICC had protected the market shares of truckers against the railroads by insisting that many railroad shipping rates be at least as high as those charged by trucks. Since trucks can provide door-to-door service, they were guaranteed those markets.

In 1979 the ICC began to deregulate the trucking industry. It relaxed entry standards by limiting the rights of entrenched companies to protest new entrants and by eliminating the requirement that existing service be shown to be inadequate before a new route authority would be granted. The ICC also permitted private carriers (for example, the trucks belonging to a supermarket chain) to haul cargo for others. The limitations on the number of shippers that a contract carrier may serve have also been relaxed. As a result of these and similar measures, over 98 percent of the recent applications for new route authorities have been granted.

In the area of rates, the Motor Carrier Act of 1980 established a zone, or range, of prices, equal to 10 percent above and below current rates, within which individual carriers can adjust their charges without ICC approval. The ICC is also considering a proposal which would use a strict rate-of-return standard for judging the reasonableness of rates set collectively.

Congress has warned the ICC not to take further deregulatory steps until it has considered motor carrier deregulation proposals fully. The 1980 Motor Carrier Act did codify most of the changes the Commission had already made with respect to relaxing entry standards, but expressly prohibited some deregulation proposals the agency was considering.

The enactment of the 1980 law will not end the debate over deregulation. The bill, which was originally opposed by the trucking industry and the Teamsters Union, was a compromise. Nonetheless, there is substantial support for more extensive deregulation. Unless deregulation as presently structured proves to be a failure in the sense that service (particularly to small communities) suffers seriously and rates escalate, further deregulatory steps may be expected within the next 5 to 10 years.

Telecommunications: The Impact of Changing Technology

Regulation of broadcasting (radio and television) came about because without some method of determining who could use the frequencies, the development of modern communications would have been inhibited by uncontrollable interference among users. Control over broadcasting started when, at the direction of Congress, regulators were empowered to license those users who would best serve the public interest. Today the Federal Communications Com-

mission (FCC) regulates the telegraph, telephone, radio, and TV industries.

The rationale for regulating the telegraph and telephone industries was to capture the purported benefits of these natural monopolies. Initially, there were several competing telephone systems in most major cities. Rarely would these companies agree to interconnect, and subscribers to one system could not call people who subscribed to another. The companies proposed that they be allowed to merge to provide universal service; in return, they offered to subject their rates to public review in a regulatory process. Governments accepted the proposal, rather than try to preserve competition and require interconnections.

The original rationales for regulation have dominated communications policy until very recently. Gradually, however, giant strides in technology and an increasing appreciation of the forces of competition have caused the FCC to move away from rigid regulation. Important milestones have been the "reregulation" (actually deregulation) of AM and FM radio by simplifying license renewal procedures and requirements and by exerting less control over program content; the *Above 890* decision of 1959, which authorized growth in private business microwave systems; the *Carterfone* decision in 1968, which ended the policy that allowed common carriers to insist that they own all of the terminal equipment used by a subscriber; and the *Specialized Common Carrier* decision that ended the Bell System monopoly in interstate common carrier communications.

The landmark *Computer Inquiry II* decision has ushered in the 1980s, establishing important deregulatory principles in telecommunications. Under this decision, Bell, GT&E, and other companies will compete freely in the customer equipment market. However, Bell must keep these competitive activities completely separate from its monopoly services. Regulation will be restricted to basic communications services (such as private telephones); on the other hand, enhanced services associated with data processing will be free of regulation. The Bell System will be permitted to compete in international telephone and data services, and the restrictions on services and on the use of selected gateway cities for international services will be removed. Finally, Western Union's legal monopoly over domestic telegraph and telex services will end.

Deregulation will greatly change communications services. Giant corporations such as IBM and Xerox are likely to begin providing new types of services in competition with Bell. Among them will be electronic mail (which will compete with the postal system). The new common carriers that came into existence in the 1970s are likely to broaden their range of services, and consumers may soon experience competition in the field of long-distance telephone service.

In broadcasting, deregulation of AM and FM radio is almost complete. The FCC is proceeding more cautiously with television, both because of its tremendous impact on American tastes, customs, knowledge, and ideals, and the enormous value of television stations to their owners. The proliferation of additional video sources—cable, subscription television, multipoint distribution service, videotapes and cassettes, and direct satellite broadcasting—makes it more likely that the trend toward deregulation of television will continue throughout the next decade. The studies of the 1970s, showing that cable television has had little or no adverse impact on "free" commercial broadcast television, buttressed a steady relaxation of restrictions on cable, culminating in extensive federal deregulation of cable in 1980. Similarly, the Commission is likely to avoid restrictive regulation of direct satellite-to-home broadcasting, encouraging free entry sometime during the 1980s.

To date, the FCC has been the principal force for change in communications policy. Most of what the Commission has done or has proposed for common carrier deregulation is now in the process of being confirmed by legislation. Regardless of whether or how soon it is enacted, such legislation is not likely to alter the present trend.

Despite the changes, the FCC is not likely to go out of business. It will still have the task of deciding which services of Bell constitute the "basic monopoly service" and of controlling their rates, and it will continue to assign the use of electromagnetic frequencies to radio and TV stations and other civilian users.

The Insurance Industry: States and Deregulation

As a result of the passage by Congress of the McCarran-Ferguson Act of 1945, the insurance industry was freed from both federal antitrust enforcement and direct federal intervention in the insurance marketplace. That act was passed to nullify a Supreme Court decision which had held that insurance was subject to federal antitrust laws. It was intended to immunize from the federal antitrust provisions most forms of collective conduct believed essential to the availability and reliability of insurance. The prevailing view was that application of the antitrust laws could only lead to insolvencies that would hurt the public and would prohibit the collective ratemaking then thought to be indispensable to sound risk-taking. The act also gave general jurisdiction over insurance regulation to the states and allowed them considerable leeway in tailoring regulations to local needs.

Shortly after enactment of the McCarran Act, most states adopted laws requiring prior approval of insurance rates before they could go into effect. Additionally, the laws generally favored joint ratemaking through ratemaking

bureaus and established barriers for companies wanting to deviate from the rates set by the bureaus.

Soon thereafter, however, a trend toward deregulation began with the gradual removal of the cartel-like restrictions. One impetus was that many insurers asked for freedom to set lower rates, possible because of cost efficiencies and refinements in the classification of risks. Larger companies discovered that pooling of loss statistics by several companies was not a prerequisite for rational ratemaking. At present, relatively few states either set rates or require bureau ratemaking without some opportunity for divergence.

A more recent trend has been the development of "open competition" laws. These permit insurers to change rates without delay, with the state intervening only in instances where rates are determined to be excessive, inadequate, or unfairly discriminatory. The structure of the property and personal liability insurance market was conducive to these changes. This part of the industry was characterized by a large number of competitors, low barriers to entry, and, in the personal lines, relatively standardized policies.

By 1979, roughly one-third of the states (representing almost one-half of all personal policy premiums) had adopted the "open competition" approach. Thus, the property and liability field has already undergone a significant degree of deregulation, while the other major segments of the industry—life and health insurance—have never been subject to extensive rate regulation.

On the one hand, the prospects for continued deregulation in the property and casualty sector at the federal level are good. Changes in regulatory philosophy, and the belief that state action might forestall attempts to repeal or limit the McCarran Act, have led state insurance regulators to develop and support a model competition bill. On the other hand, the outlook for further deregulation at the state level is clouded by an accelerating debate over perceived problems in the availability and affordability of insurance to all citizens. This debate reflects the fact that some kinds of insurance, such as that for automobiles and homeowners, are either required by state law or are economically necessary, for example, to obtain financing. Added regulation is said to be essential because such coverage is unavailable or is priced unfairly, in part because of allegedly discriminatory rating factors such as geography (red-lining), age, sex, and marital status.

Concern over the availability of and discrimination in insurance reflects a view that government should give greater weight to social equity than to the cost of coverage in regulating insurance. Proponents of more regulation contend that society should make insurance available to everyone at a price within his reach, even if that requires subsidization of high risks. Some advocate a common carrier

approach, requiring insurers to take on all customers at near-uniform prices and terms.

Opponents of this view point to the experience of states with open competition laws which, they say, demonstrates that insurance is cheaper and more widely available under competitive conditions. It is further argued that intrusive regulatory solutions lead to market distortions that reduce the availability of insurance and pose questions of fairness, as low-risk policy-holders would have to subsidize higher risk ones. There is a middle view which holds that anti-competitive regulation, such as residual market mechanisms requiring insurer participation, should be limited to sub-markets where availability problems are particularly acute.

Although the outcome of this debate is unclear, it is likely that a significant number of states will pass some form of anti-discrimination legislation. The National Association of Insurance Commissioners is now studying, for example, a direct prohibition on the use of sex and marital status as rating variables.

At the federal level, the short-term prospects for repeal or amendment of the McCarran Act are not favorable. Recently Congress reaffirmed its policy of deference to state regulation by prohibiting the Federal Trade Commission from conducting studies of the "business of insurance" except as requested by Congress. Also recently, however, the Supreme Court decided two cases, *Royal Drug Company* and *St. Paul Fire and Marine Insurance Company,* which significantly restricted the scope of the McCarran Act's antitrust exemptions. Thus, the direction at the federal level is uncertain.

The Energy Sector: Coping with Scarcity

The rapid rate of increase in energy prices during the 1970s, coupled with the nation's dependence on imported oil, has provoked serious reconsideration of all facets of energy policy in the United States. In the past decade the attitude toward economic regulation of the energy sector has gone full circle. The immedate response in the early 1970s was to increase the scope and rigidity of energy regulation, subjecting crude oil prices and allocation to control for the first time and holding down electric utility rates far more rigorously than had been the case in the preceding 20 years. These actions led to a financial crisis in the electric utility sector. The regulation of the field price of natural gas, implemented in the 1960s, contributed to reduced domestic production of oil and gas. However, by the end of the decade, the government had reversed its policy. Instead of placing primary emphasis on protecting consumers from the effects of rising international energy prices, consumer prices were allowed to move up toward the world level.

Oil and Natural Gas. By the middle of the 1980s, deregulation of domestic supplies of oil and gas is expected to be essentially complete. This will mark the end of a 30-year cycle that started in the 1950s.

The pressure to regulate natural gas, and later oil, arose from a chain of events. From World War II on (in fact, into the late 1960s), domestic energy prices in the United States were substantially lower than elsewhere in the world. As a result, American production techniques and lifestyles were based on heavy use of energy.

In the 1950s, new domestic oil and natural gas reserves became more expensive to exploit. The price of oil was kept down, however, by cheap resources from the Middle East. The price of natural gas, on the other hand, rose substantially. Those producers whose production costs remained low got greater than normal, or windfall, profits as a result of the high prices. Consumers, such as utilities, who were affected by the increased expense of energy and who believed the windfall profits to be inequitable called for price controls and limits on profits. In 1954, a group of midwestern gas utilities won a Supreme Court case that required the Federal Power Commission (now the Federal Energy Regulatory Commission) to regulate the price of gas at the wellhead. Several years later the Federal Power Commission instituted field price regulation of natural gas. The idea, applied in the 1970s to the regulation of oil prices as well, was to set a uniform price for all wells in a particular geographical area. The price was based upon average production costs of all those wells.

The field price system, after it has operated for a while, generates "tiers" of oil and gas—different categories of the resource that have different prices because of differences in costs. This situation raises the question, to be decided by regulators, of who is to use the cheapest oil and gas and who is stuck with the newer, more expensive fuels. The result is allocation—formal rules setting priorities among users and distributing the burden of paying for the new sources. In the oil business, these allocations are especially complex because oil is refined in a complicated process in which it is impossible to assign costs in a non-arbitrary way among all of the numerous petroleum products.

Because oil and gas users are both numerous and highly heterogeneous, government allocations are at best rough approximations of the most efficient and equitable distribution of these fuels. In times of crisis, the system has been sufficiently cumbersome to cause major shortages, best illustrated by the gasoline lines in 1979. Both before and after the cutoff of Iranian oil, there were more than adequate supplies to meet all the demand for gasoline, heating oil, and other petroleum products at then-current prices.

The shortage had two causes. First, regulators overestimated the demand for heating oil and insisted that companies produce more heating oil than was eventually needed. Second, the allocation system gave small refiners proportionately more oil than large refiners, and small refiners generally devoted less of their production capacity to gasoline than did large refiners. Although the President had announced his intention to deregulate oil before this event, the gasoline shortage made the plan far more acceptable to Congress and the public.

No single dramatic event has highlighted the problems of the regulation of natural gas prices. Nonetheless, the evidence that regulation was simultaneously wasting supplies of natural gas and inhibiting the development of new supplies grew in the 1970s. In 1978 Congress passed the Natural Gas Policy Act, which will lead eventually to deregulation, although the transition will involve a complex system of gradual price increases.

As oil and gas prices have risen, Americans have become more frugal in their use of energy. The gas mileage of new cars purchased in the United States is running well ahead of the mandatory fleet mileage requirements enacted in 1977, even though at the time those requirements were considered unrealistic by some, given America's affair with the automobile. The shortages of natural gas that were forecast in the early 1970s on the basis of projections of past growth in consumption and reduced reserves have not materialized, considerably easing the pressure to convert industrial boilers to coal. Finally, it now takes 25 percent less energy to produce a constant dollar of GNP than in 1973, when the OPEC cartel first successfully set world oil prices.

As long as supplies remain limited, new reserves continue to be more expensive, and deregulation is extended, oil and gas prices will rise. In the long run, they are likely to stabilize only if demand slackens and new supplies are found that are economically, politically, and environmentally feasible to produce.*

Utilities. The 1970s was an era of change in the regulation of utilities. As fuel prices increased dramatically and inflation pushed the capital costs of new generating plants to several times the cost of older plants, utilities faced the end of a long period of declining prices. State regulatory commissions accustomed to hearing 3 or 4 rates cases per year suddenly were faced with 10 times that number; new requests for price increases were being filed before the

* Many claim that the United States can produce more oil and natural gas through processing oil shale and coal than is found in Saudi Arabia. However, significant economic and environmental problems remain to be solved in converting these minerals to useful forms of energy.

previous requests had been decided. The regulatory process, designed to deal with declining energy costs, simply broke down and had to be reconstructed.

The first major change was the automatic fuel cost adjustment, whereby utilities were allowed to pass through increases in oil, gas, and coal prices without a formal hearing. The technique had adverse side-effects, since it removed some of the incentive for a utility with a protected market share to seek the least costly source of energy. Other major changes took place in capital cost accounting and the treatment of expenditures for plants during construction. The purpose of these changes was to make the workload of regulatory commissions more manageable and to avoid severe financial hardship to several utilities.

A second, far more fundamental change in regulation is underway. It is reform of the structure of prices that utilities charge. Historically, utilities, especially electric companies, charged "declining block rates." That is, for each category of user, the price of energy declined as total energy use increased. This rate structure provides an incentive for greater use of energy because additional increments of fuel cost less.

Because new energy sources are more expensive, the incentive to consume created by the declining block rate is inconsistent with the cost of producing energy and the national policy to conserve energy. Rate reform seeks to tie prices more closely to costs so that electricity is used only if its value to the user exceeds its cost. This means the price of energy should be varied as conditions of supply and demand change so that, for example, higher prices would be charged for energy consumed at times of heavy use.

Following the pattern in other developed nations, utilities in the United States have been using the peak-load pricing system with greater frequency. Demand is much higher at certain times of the year—the air-conditioning season in August and the coldest parts of the winter—and at certain times of the day—mid-afternoon rather than in the middle of the night. To satisfy these extreme demands requires construction of "peaking" plants—that is, generation equipment that is not used most of the time. Because it is not used frequently, utilities normally use less efficient equipment for peaking plants. While they may save on capital costs, they may have to use greater amounts or a more expensive type of fuel.

The idea behind peak-load pricing is to charge more for electricity during the peak demands than at other times. Where power demands are flexible, the price differential will encourage conservation in the peak periods and a shift in energy use to off-peak hours. The result would be lower average prices, because some expensive peaking plants could be avoided *and* less energy used. Recently economists

at the Rand Corporation estimated that 30 percent of the capacity increases that are projected for the Los Angeles area between 1980 and 2000 could be avoided through the use of peak-load pricing.

Federal policy in this area is to encourage cost-based pricing of electricity. In response to the Public Utility Regulatory Policy Act of 1978, which called upon states to consider peak-load pricing policies, several states are now studying its application, and it has been tried experimentally a number of times.

Implementation is not without controversy, for any attempt to make pricing more efficient may cause some customers to end up paying more. Individuals and businesses who have made long-term investments with the expectation that pricing policies would not change, whether they were in all-electric homes or continuous production processes that cannot readily vary energy use in response to periodic variations in price, may view a switch to peak-load pricing as unfair. On the other hand, more flexible users consider peak-load pricing as a way of reducing escalating utility bills and avoiding the construction of new, expensive, polluting peak-load plants. These conflicting interests will shape the debate over utility pricing and the nature of the reforms that will be made. Nevertheless, during the 1980s, commercial and industrial users of electricity, and perhaps residential users in some areas, can expect major reforms in pricing.

End-Use Regulations. In the late 1970s, federal, state, and local government became active in regulating the use of energy by both businesses and individuals. The fuel economy standards for automobiles are a well-publicized example. Others include mandatory disclosure of the energy efficiency of appliances, allocations of fuel among industrial users, standards for insulation of new buildings, curtailment of the use of natural gas for heating swimming pools, and the President's standards for the internal temperature of public buildings. This type of control over end-uses is perhaps the most controversial area of energy regulation. Some argue that these regulations are necessary to force Americans to conserve energy. Others argue that, with the deregulation of oil and gas prices and the introduction of more rational pricing structures in the utility sector, these regulations amount to overkill and will achieve nothing beyond that which will result from rational pricing.

Whatever the merits of these regulations, they are likely to remain in place for several years. Many citizens and political leaders lack faith in the ability of the market system to induce adequate conservation and innovation in the supply of energy and will continue to support this type of regulation until its necessity is disproven.

Two areas of regulation are likely to expand and become permanent. One is building codes relating to the energy efficiency of buildings; the other is informational requirements on appliances and machinery. The latter facilitate the workings of the market by improving the ability of purchasers to make informed decisions and are not expensive to implement and enforce. The former are rooted in a heavily regulated industry, construction, in which regulation has proven durable. Part of the reason no doubt is that by the time a building is purchased, many of its structural features cannot be readily observed by a prospective owner. Building codes assure some minimum standards without an owner having to supervise construction.

The durability of other end-use regulations depends on two factors: (1) the extent to which market forces induce substantial conservation by consumers and persuade industries to make products that use less energy; and (2) whether in the coming decade new energy supplies are developed that, along with conservation, alleviate the energy problem. Neither factor is likely to be resolved much before the end of the 1980s.

Financial Institutions: Changing Regulatory Goals

The first instance in the recent wave of economic deregulation of financial institutions occurred in 1975, when the Securities and Exchange Commission deregulated brokerage commissions for sales of securities. At the time, opponents saw free market conditions as a threat to the stable operation of the securities markets and to the solvency of smaller brokers. These fears have, for the most part, not materialized. Instead, deregulation has led to generally lower fees and a differentiated industry in which some brokerage houses successfully charge higher fees while providing greater services to their customers. Moreover, the securities markets have remained highly open and competitive.

Buttressed by this success, the federal government has embarked on an even more extensive program of reducing economic regulation of depository institutions (primarily banks, savings and loans, and credit unions). The ceiling on the amount of interest that depository institutions may pay depositors—known in the trade as Regulation Q—is being carefully phased out over the next six years according to the provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). Intended to discourage the shift of funds from savings-and-loans to commercial banks (thus safeguarding the home mortgage market), Regulation Q has now been judged by Congress to have intolerable costs. It discriminates against the small saver, who must accept a maximum five-and-a-half percent return, while allowing more affluent savers access to the considerably higher "market" rate of interest.

Furthermore, by diminishing the incentive to save, it fuels inflation and reduces the capital available for investment.

Paralleling deregulation of the interest rates *paid by* financial institutions is a gradual movement toward decontrolling the interest rates *paid to* financial institutions. Historically, lenders have been subject to state usury laws, which place a ceiling on the amount of interest that may be charged on any loan to an individual, but not normally to a corporation. Over the last decade, states have responded to periodic economic pressures—a general shortage of money for loans caused by artificially low interest ceilings—by raising the usury limits. For example, a dozen years ago, most usury laws prohibited interest in excess of 8 or 10 percent; nowadays, interest rates over 15 percent are both legal and common.

The alternative to repeatedly raising the interest ceiling would be to eliminate usury laws altogether, as has already happened in South Dakota. At the federal level, interest ceilings on federally funded home mortgages are being phased out gradually. Federal law also makes state usury laws inapplicable to other kinds of loans unless a state passes a law specifically making the usury ceiling apply to the covered types of loans. By the end of the next decade, government is likely to exert little, if any, control over the amount of interest charged on loans, whether it does so by repealing usury laws or by simply setting interest ceilings well above prevailing market rates.

The new DIDMCA also encourages the spread of the highly popular negotiable order-of-withdrawal (NOW) accounts, first offered by state-chartered institutions in Massachusetts and New Hampshire in 1972. The NOW mechanism gives depositors the functional equivalent of an interest-bearing checking account. The law also authorizes a similar device (called the "share draft") for federally insured credit unions, permits commercial bank customers to have funds transferred automatically from their savings accounts to checking accounts, and provides savings-and-loan customers instant access to their accounts through terminals off the premises.

DIDMCA also allows federally-chartered savings-and-loan institutions to handle trusts and offer credit card services. These institutions are also authorized to engage in a wide variety of consumer lending, including commercial real estate loans, education and community development loans, corporate debt securities, and other types of loans. The scope of financial activities permitted to credit unions has also been expanded. These and other changes will reduce or erase most distinctions between credit unions, savings-and-loan institutions, and commercial banks.

Not only are the differences between depository institutions disappearing, but recently there have also been

controversial proposals to allow commercial banks to compete with brokerage firms in some areas. Specifically, banks are seeking the power to manage and sell mutual funds and to underwrite revenue bonds. The underwriting proposal was part of early versions of the DIDMCA but was dropped in response to strong opposition from the securities industry. If adopted, these changes will signal a trend toward even more deregulation of banking.

The extent to which government should establish anti-competitive geographic restrictions on the operations of depository institutions will also be a controversial issue in the 1980s. Currently, the McFadden Act and Douglas Amendment restrict interstate operation of banks, and numerous states limit the number of branch offices that a single bank can maintain. These restrictions indirectly limit a bank's size and are thought to make it vulnerable to takeovers by foreign investors, a phenomenon which occurred frequently in recent years.

In response to concern about foreign takeovers and growing foreign investments in American banks, Congress has directed that an interagency task force consider recommendations to remove some of the existing restraints on interstate banking operations. At the state level, some banking groups, as well as consumers interested in greater convenience, have been trying to repeal the limits on branches.

Of course, deregulation has costs and risks. It places a substantial burden on savings-and-loan institutions to compete for depositors. Some warn that NOW accounts will work to the disadvantage of low balance, high activity customers. In Congressional testimony, the Independent Bankers Association cited studies showing that NOW accounts significantly reduced the after-tax earnings of commercial banks in Massachusetts and New Hampshire. Others fear the uncertainty posed by so massive a change in the operations of the banking system. Nevertheless, the trend is clear, even if the ultimate outcomes are not, and banks will never again be the same.

While the 1970s brought substantial deregulation to the banking industry and the 1980s may bring more, some argue that the net regulatory burden on financial institutions increased during the 1970s. In that period, nearly a dozen new laws affecting the banking industry were passed to protect a variety of consumer interests. Two laws, the Truth-in-Lending Act and the Home Mortgage Disclosure Act, require lenders to give consumers a better understanding of the financial and legal consequences of many familiar loan agreements. Congress also enacted the Equal Credit Opportunity Act to prohibit discrimination in loan practices based on race, sex, or age.

Still another group of laws was designed to protect the reputation or privacy of consumers. The Fair Credit Billing

Act provides that credit companies may not threaten to damage a person's credit rating if he refuses to pay a bill containing an error. Another new law, the Fair Credit Reporting Act, allows people to challenge the accuracy of reports concerning their fitness to obtain credit. A more recent law also assures people that the advent of electronic fund transfer systems and computerization of financial transactions will not lead to invasions of privacy.

Yet another group of reforms, most contained in the Financial Institutions Regulatory and Interest Rate Control Act of 1978, are designed to assure the financial integrity of financial institutions. Congress placed severe limits on the financial dealings between insiders and the institutions with which they were associated, broadened the prohibitions on ties between management and directors at different financial institutions, and strengthened the enforcement powers of regulators. Finally, in order to strengthen the government's control over the supply of money, the recent DIDMCA extended the reserve requirements (the percentage of savings which a bank may not use to make loans) to all depository institutions.

The 1980s may bring a reassessment of some of the laws designed to protect consumers. Among other issues, regulators will need to consider the fairness and effectiveness of dividing the responsibility for enforcement of the equal credit opportunity and related laws between the financial regulatory agencies (for financial institutions) and the Federal Trade Commission (for non-financial businesses). In addition, complaints about the burdensome disclosure and time limit requirements of the Truth-in-Lending laws may lead to reconsideration of that program. Finally, the rapid changes in the banking industry may well bring to light new consumer problems which will require corrective legislation.

Health Care Costs: The Great Anomaly

The one important area of the American economy in which economic regulation is growing is the health care sector. In the past two decades, the share of medical care in the Gross National Product has doubled. This reflects, in part, a substantial expansion of the availability of care, an objective of health policy since the early 1960s. However, as federal expenditures for care for the poor and the elderly have increased, and as insurance coverage has expanded to include nearly all of the working population, prices for health care have risen rapidly, outstripping the overall rate of inflation.

In the 1970s, government responded to the growing financial burden of health care by expanding economic regulation of the industry. Most states enacted laws regulating hospital prices and controlling the growth of hospital capacity. Recently Congress considered, but rejected, a

proposal to establish a maximum rate of growth of hospital revenues and to establish a regulatory mechanism to carry out that policy.

The problem of rapidly rising expenditures for medical care will continue to be a major issue in the 1980s. The costs are obviously straining government budgets—both through direct expenditure programs such as Medicare and Medicaid and through the indirect costs (lost revenue) of making medical expenses and health insurance premiums tax-deductible. In addition, rising costs have been a major barrier to the development of a comprehensive national health care policy. Officials are rightly concerned about the budgetary and inflationary effects of further federal financing of care in a system in which costs cannot be brought under control.

Already the evidence is mounting that economic regulation is not controlling costs. Although a few states have been able to lower the rate of increase of medical care expenditures, most have not, and no systematic relationship has emerged between the scope and vigor of regulation and the escalation of expenditures.

The problems of economic regulation of the health care sector are immense. Because medical care is tailored to the needs of each patient, it is virtually impossible to specify standardized services which can then be subjected to price controls. Moreover, the industry has literally hundreds of thousands of individual providers, each of whom makes decisions about patients based on subjective judgments. To second guess these decisions through a regulatory process is all but impossible. Thus, the best that can be hoped for in regulation is to weed out the extreme cases, rather than to control the behavior of the entire industry.

It has been argued that the primary cause of rising expenditures for medical care is its payment mechanism. Neither providers nor patients have an incentive to hold down costs if the bills are automatically paid by a private insurer or the federal government. To reverse the trend of rising costs will require changing the market for care.

One approach is to give patients more incentive to reduce costs by requiring the patient to pay a percentage of the cost (known as coinsurance) or by including deductibles in insurance policies. However, coinsurance would increase a person's financial exposure in the case of serious illness.

Another approach would encourage the establishment of a variety of health insurance plans, differing in their costs and coverage. With the appropriate information, consumers could compare the different plans and choose the one that best meets their needs. Presumably, some insurers would offer "closed panel" plans that would reimburse consumers only when they used a health care provider

(such as a doctor or a hospital) that had promised the insurer to deliver services at a certain price. These closed panel plans would encourage health care providers to make their prices competitive. Moreover, since closed panel plans often cost less than comparable plans that contain no restrictions on a consumer's choice of providers, other insurance companies would have an incentive to find ways to contain their own insurance premium costs. Thus, encouraging a diversity of insurance plans, including closed panel plans, would create a more competitive market for health care and would ultimately lead to lower overall medical costs.

This system is in marked contrast to the typical plan today; nearly all private and public insurance plans reimburse patients for reasonable medical care provided by essentially any doctor and hospital. The quantity of care is determined by a doctor, and the prices by historical experience with costs and by conventional local practices. The insurer passively accepts both decisions.

In some areas of the country, consumers already have a limited choice between an insurance policy that covers services and hospitalization at any hospital (open-panel insurance) and membership in a group practice plan. This limited competition has served to keep medical care costs lower than in areas which do not have a large group practice organization.

Even with the competitive approach, there would still have to be some regulation. Government would have to develop policies on enrollment and minimum coverage requirements for plans offered by employers or that enroll consumers receiving subsidies. Informational requirements would be necessary to assure that consumers had adequate facts about costs and the quality of care so that they could make informed decisions about competing plans.

The history of economic regulation, in medical care and elsewhere, provides little reason to believe that use of regulation as the primary means of controlling costs will solve the problem. The alternative to regulation in this sector is to reintroduce competition into an industry which, since the development of extensive insurance coverage, has become insulated against a concern over costs. Until such structural changes are made in this sector, the public and private burden of medical care expenditures is likely to grow more severe and to remain high on the agenda of important national problems.

In 1979, Congress indicated some awareness of these arguments. Reviewing a long-standing legislative provision that competition has no place in medical care, the Congress authorized states to experiment with some limited competition as a means of controlling costs. Virtually simultaneously, Utah enacted the first state regulatory statute that

explicitly encourages the use of market forces to control medical costs. While these events hardly constitute a trend, they do indicate that competition or regulation in the medical care sector will be on the agenda for the 1980s.

Economic Deregulation —The Time Has Come

During the 1970s, economic deregulation advanced on many fronts: airlines, brokerage fees, oil and gas pricing, to name a few. The experience in these areas confirms the predictions of those who forecast that deregulation of service industries will encourage competition and innovative services while containing prices. In view of the clear benefits of economic deregulation, the Panel strongly supports continued movement toward the removal of government controls on prices, profits, and entry.

The Panel stresses that economic deregulation is not synonymous with the absence of any kind of regulation. Rather, government would rely more on competition in the marketplace, using antitrust laws to maintain it, and on the forces of supply and demand, instead of regulation, to determine the price of goods and services. Effective enforcement of the antitrust laws is particularly important in recently deregulated industries; one common result of deregulation is a spate of merger proposals as companies seek to rationalize their services after artificial regulatory barriers to efficient business operations are removed.

Moreover, economic deregulation will not necessarily entail any relaxation of other kinds of regulation. Appropriate regulation of worker safety and consumer protection should be continued, and possibly expanded in some cases, in the wake of deregulation of an industry.

Finally, the Panel also expresses concern that regulators should be sensitive to the problems of industry and consumers that will accompany the transition to an unregulated marketplace. If recognized and dealt with, government can minimize disruption and avoid the possibility that transitional problems will hinder deregulation by focusing debate on the exceptional issues. Two approaches, providing subsidies for services for small communities and automatic approval of rate adjustments falling within a "zone of reasonableness," have been used successfully to ease transitional burdens accompanying deregulation in the transportation sector.

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Chapter 8

Environmental Protection AND Worker Safety

Throughout the 1970s Congress passed major new laws and strengthened old ones in the fields of environmental quality and worker protection. This expanded federal commitment to occupational safety and environmental protection is likely to endure through the 1980s. In fact, while the government may eliminate most kinds of economic regulation by the end of the decade, its activity in these areas may well expand. There will, however, be pressure to examine new methods of selecting, pursuing, and enforcing policy objectives—pressure that reflects the broader re-examination and evolution in regulatory philosophy. The pressure will be directed primarily toward regulatory techniques (see Chapter 3) and the level of government at which regulation should be implemented (see Chapter 4).

Air and Water Pollution

The principal focus of the environmental legislation of the late 1960s and early 1970s was to clean up the more obvious forms of air and water pollution. For the most part, regulators (the Environmental Protection Agency in cooperation with comparable state agencies) have required specific kinds of changes in production processes—input standards—after intensive investigation of the technologies available and their costs. Examples are catalytic converters on automobiles, stack-gas scrubbers on coal-fired boilers, and waste treatment facilities for sewage systems.

Input regulations of this type are less difficult to enforce because it is relatively easy to determine whether the required equipment has been installed (though it is less easy to determine whether it is kept on line and properly maintained). However, techniques for evaluating the effect of emissions control on air quality are still so imperfect that it is not always clear how much such equipment contributes to improving ambient air quality. Moreover, in the field of air quality, such equipment is required routinely only for new sources of pollution. Because old sources are subject to emission controls that arise out of state rather than federal implementation plans, enforcement turns on

criteria that are less clearcut, and enforcement tends to lag. In addition, emissions controls often require continuous monitoring or sophisticated sampling techniques, which are expensive.

In general, there seems to be a tradeoff between ease of enforcement and customizing regulations to fit individual cases. Input regulations are easier to enforce but fit individual circumstances less well. Customized regulations are harder to enforce for a variety of technical reasons and afford an endless opportunity to argue about the exactness of fit. In theory, it would seem that polluting industries would call for more customized regulations, since they instinctively dislike technology-based (input) controls. However, in practice, they also generally object to proposed customized regulations, resisting them with lawsuits and political appeals.

To date, there has been significant progress in improving the quality of the environment. Ultimately, that is the basis on which society will judge the success of environmental regulation. However, there are critics who dispute these achievements, asserting that quite costly regulations have been imposed without sufficient evidence of effectiveness. Regulators are said to be too prone to measure success in terms of how many standards have been written or how many firms are in compliance rather than by overall improvements in the quality of the environment.

The current regulatory approach to environmental protection is to set standards. Some argue that this approach is not always well-suited to reducing pollution. Opponents include both businessmen and environmentalists, the former on grounds of cost, the latter because of ineffectiveness. They claim that this approach cannot take into account the variation in costs to firms per unit of pollution abated. Furthermore, they claim that regulators often choose a standard for its ease of application, rather than its anticipated outcome. On the other hand, proponents of standard-setting note the advantage of a clearly defined level of protection. Further, this approach leaves the firm free to choose the means of reaching the standard.

Recently, both federal and state regulators have experimented with more decentralized forms of regulation. One example is the "bubble concept"—a form of tradable emissions permit. Regulators set an overall limit on the amount of pollution that one firm may produce. Each firm may use its facilities as it wants, as long as the total amount of pollution does not exceed the limit. Another example is the offset policy. In areas where total pollution is at or above the acceptable level, a firm can construct a new facility only if it can get other firms to abate their pollution by an amount whereby the total pollution of all firms will fall below the maximum permissible level.

The use of emissions taxes is also being actively considered for some specific types of pollutants. For example, annual automobile inspections could be combined with an emissions monitoring program. The emissions could be taxed according to the amount by which they exceeded some minimum level, preferably a level substantially below current new car standards in order to provide an incentive to improve future emission control systems. The tax could be substituted for registration fees so that the net financial impact would be minor. To avoid unrealistic costs to the poor, who tend to drive older cars that have greater emissions, exemptions could be granted for vehicles beyond a certain age. In addition, to assure some minimum degree of compliance, vehicles could not be registered unless their emissions fell below a maximum level. Regulators thus would have to set two standards: a minimum level of emissions beyond which emissions would be taxed, and a maximum level beyond which vehicles would not be permitted on the road.

For some pollutants, a regulatory system that relies on market forces is likely to prove feasible in the near future. For example, tradable emissions permit schemes for regulating sulfur emissions are being considered in several states; a similar mechanism for controlling emissions of chlorofluorocarbons has been worked out and is being considered by the EPA.

While decentralized, market-like approaches are certainly not panaceas—protecting the environment will always cost money and will never be characterized by perfect efficiency—decentralized approaches that rely on market forces, though imperfect, do hold promise in some important areas of environmental policy. A major issue in the 1980s will be the extent to which these approaches will be used in place of the current regulatory process.

Managing Toxic Substances

A major issue in the 1980s will be the disposal of hazardous wastes and the management of toxic chemicals. The disaster at Love Canal—an abandoned dump for toxic chemicals that has left an entire neighborhood near Niagara Falls, New York virtually uninhabitable—has made clear the need both for better controls in the future and for a program to clean up dangerous sites now in existence. The EPA estimates there are 30,000 to 50,000 existing hazardous waste disposal sites and that 300 billion pounds of chemicals are added to them each year. An undetermined number of these sites may be as dangerous as Love Canal. Legislation to create a fund to clean up existing sites was recently passed by Congress.

The controversy over toxic chemicals in the workplace, the air, and the water will continue in the 1980s as understanding of their harmful effects grows and as it becomes more possible to detect smaller amounts of such substances.

In addition, the ability of science to identify potentially toxic chemicals, including not only cancer-causing substances but also chemicals which affect human reproduction, is improving. Since the number of women in the workforce is increasing and one couple in every six trying to conceive is infertile, toxicity affecting reproduction is likely to be an increasingly important concern.

The dimensions and complexity of the problem of toxic chemicals are better understood now, and it is potentially much larger than originally thought. Numerous untested chemicals are currently in commercial production, and approximately 500 to 1,000 new ones are introduced into the environment each year. Yet, according to the EPA, this country has the resources to evaluate thoroughly only 250 compounds a year. Even if each chemical could be tested, the data would not predict synergistic effects—that is, two substances interacting together (such as asbestos and cigarette smoke) to produce more serious harm than either produces alone. Scientific understanding of synergistic phenomena is still highly limited. Because of this uncertainty, the country will continue to face difficult choices about which chemicals to investigate, how thoroughly, and what to do about those that have not been completely evaluated.

One possible strategy for regulating toxic chemicals, particularly in the workplace, is to use a generic approach. Under this approach, agencies would establish general rules that impose specific restrictions on the use of any chemical that is shown to have a certain level of risk. This would avoid the time-consuming process of collecting large amounts of information and carefully weighing the individual risks and benefits of a number of chemicals, as has been done in the past with drugs and pesticides. Agencies could deal with many more chemicals than they currently do. To adopt this approach, however, would necessitate changing the provisions found in most of the statutes covering toxic chemicals that require a chemical-by-chemical decisionmaking process. Such amendments will encounter significant resistance since any generic approach will inevitably lead to some degree of overregulation. At least a few chemicals would be banned or restricted which pose risks that society later determines to be acceptable.

Finally, there will continue to be controversy whenever agencies propose to make public information considered a "trade secret" by chemical companies. Chemical companies claim that disclosure of the identity of a new chemical compound will allow other companies to compete more effectively and quickly with the firm that originally developed the compound. Similarly, disclosure of the chemicals used in the workplace (particularly compounds formed at the intermediate stages of manufacturing) could enable competitors to determine how another company

makes a purer, cheaper, or more effective product. These legitimate business interests must be weighed against the strong interest of workers and the general public in understanding the risks they bear from being exposed to potentially harmful chemicals.

Environmental Issues Relating to Energy

Major health and safety questions have arisen in connection with most energy options—coal, synfuels, or nuclear—which the United States might adopt to meet its future energy needs.* Among the issues raised by increased use of coal will be how best to protect the health and safety of miners and how to handle the land from which coal is strip-mined. The burning of coal produces sulfur dioxide, which is thought to combine with moisture in the atmosphere to form dilute sulfuric acid, or "acid rain," as well as other atmospheric pollutants. The synfuels industry, especially coal gasification and oil shale, will require tremendous amounts of water—a scarce resource in the western United States where the most abundant reserves of these fuels are found. That industry may also generate both significant amounts of hazardous waste and new, untested chemicals. Finally, there is nuclear power. It involves not only the risk of proliferating nuclear technology, but also the relatively unlikely, but catastrophic, possibility of a reactor meltdown. In addition, the consequences of exposure to low levels of radioactivity from minor reactor accidents or from nuclear wastes are uncertain, but involve the possibility of cancer, birth defects, and other genetic diseases.

Long-Term, Global Environmental Problems

Two issues that emerged in the 1970s illustrate a class of long-term, potentially severe, global problems that are likely to be a concern of the public in the 1980s, although it is difficult to predict whether they will become a focus for action. The two are the depletion of ozone in the upper atmosphere as a result of chlorofluorocarbons, and the possibility that continued emissions of carbon dioxide (CO_2) will warm the atmosphere. Ozone depletion could lead to increased skin cancer and other undesirable effects resulting from changes in the kinds of radiation reaching the surface of the earth. Atmospheric warming from CO_2 could cause major climatic shifts around the globe, with possibly important effects on the distribution of agricultural activity, water resources, and even the level of the ocean.

* The Commission's Panel on Energy, Natural Resources, and the Environment discusses these questions in much greater detail. That Panel recommends that the country try to reduce its dependence on foreign sources of energy by vigorously conserving energy. This path, of course, would involve the fewest environmental problems.

One difficulty with this type of problem is that action may have to be taken before enough information is available to determine whether the threat is real or what its magnitude is. Therefore, decisions must be made in the face of substantial uncertainty.

Because of their mandate to defend national interests, governments have difficulty dealing with complex, unproven risks of global scope. Their probable response will be to continue to research and debate these and other global environmental issues, delaying action until more convincing evidence emerges. In the case of chlorofluorocarbons, however, although much of the information is still conjectural, the case for international control is strong, since relatively effective substitutes are available and in use in the United States. The appropriate response to the CO_2 problem is more difficult to determine, since there is no easy, short-term method of reducing significantly the combustion of hydrocarbon fuels, a principal source of CO_2. Thus, the problem of a build-up of CO_2 is ongoing, and it is likely to grow as more fuel is burned in the coming years. However, the ultimate impact may not be apparent for several more decades. In this situation, the best short-term strategy may well be to gather more information, because the adverse effects of a CO_2 build-up are not expected to occur for several decades. This gives society some time to analyze the problem and possible solutions to it. But ultimately decisions will have to be made before the relationship between atmospheric composition and climate is fully understood.

A similar problem involves preservation of the variety of species existing today. Although its figures are subject to controversy, a recent study concludes that 20 percent of the plant and animal species on earth today will be extinct by the year 2000. This issue has significant policy implications. It is known that food, medicine, and gene stocks for domestic plants and animals derive from the variety of species on earth. It is also commonly believed that all plant and animal species are interdependent. What is not clearly understood is the nature of that interconnectedness and the impact that destruction of one link can have on the environmental chain as a whole. Aside from this practical argument, some people also advance moral and aesthetic reasons. They place a high value on preserving as many species as possible and regard the loss of even one as a serious degradation of the world.

Reflecting public opinion and values, government has adopted a policy of preservation of the species, as illustrated by recent attempts to save the whooping crane, snail darter, and California condor. Moreover, much effort has gone into preventing the international whaling industry from exterminating those large mammals.

These types of issues are certain to become more important in the 1980s and beyond. Population growth and industrialization, especially in less developed areas, will put increasing pressure on species. These problems are global, for all of humanity benefits from the diversity of life forms on earth. However, as the international whaling negotiations demonstrate, progress will be slow and difficult, especially where major economic interests are at stake. Certain actions to protect endangered species are proceeding more slowly than the threats to them, and that fact will lead to an intensification of the debate in the coming decade.

Conclusions

Solving many of the regulatory issues involving the environment and worker safety will require tradeoffs between the strongly-held interests of different social groups. Society will have to find a balance between such controversial interests as: costly land reclamation of stripmining operations versus economic efficiency and cheap fuels; the acceptable degree and distribution of risks from the use of socially beneficial substances such as pesticides and industrial chemicals; and the level of control to impose on automobile exhaust and emissions by industries burning fossil fuels, versus the cost of regulation to consumers and to the economy in general.

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Chapter 9

Consumer Protection

A number of regulatory programs are intended to protect the interests of consumers. Examples of the more traditional ones cover the quality of food, the safety and efficacy of drugs, the safety of motor vehicles, truth-in-lending, and truth in advertising. Occupational licensing is also regarded as consumer protection. Finally, much of the regulation of the fundraising and lobbying activities of nonprofit organizations, like regulation of business, is intended to prevent misrepresentation. All these issues will be of concern during the 1980s.

Traditional Consumer Protection

Traditional consumer protection programs are likely to be the subject of considerable controversy during the 1980s as they were during the late 1970s. In the early 1970s Congress had given strong support to consumer protection regulation when it passed the Consumer Product Safety Act and strengthened the authority of the Federal Trade Commission. More recently, it has been more cautious. Not only has it refused to pass legislation creating a consumer advocacy agency, but its actions during the FTC reauthorization hearings of 1979-1980 suggest that the proper role of government in protecting the consumer is still undecided.

Much of the debate will center on deciding what should be regulated. This point is exemplified by the controversy over artificial sweeteners, which came to the fore in the 1960s with cyclamates, and again in the late 1970s with saccharin. Given experimental results showing that each could cause a greater incidence of cancer in animals, the Food and Drug Administration (FDA) proposed a ban on their use in food, as the law then required. The public's reaction each time was generally hostile. Cyclamates were eventually banned, with saccharin available as a substitute; that ban remains in force today. The proposed ban on saccharin, which would have left no adequate substitutes, was never imposed. Ironically, most consumers preferred the taste of cyclamates to saccharin. Moreover, the evidence against saccharin is generally considered stronger than the evidence against cyclamates. Debate continues over what, if

anything, ought to be done with saccharin. Some people think that the FDA should take no regulatory action, while others believe it should require nothing more than warning labels on foods that contain saccharin. The question of whether cyclamates should be permitted again has not been seriously addressed.

The artificial sweetener debate is an example of a fundamental issue for the 1980s: should government intervene in cases where the consumer has control over the risk, in contrast to other situations in which consumers are unwilling victims, as is the case, for example, with respect to pollution? A decade ago, officials opted for substantially more controls on consumers' decisions. The general idea was to identify products and activities that posed health and safety threats to consumers and, through bans and regulatory standards, to eliminate them. The difficulty was that in some cases consumers preferred taking the risks to eliminating the hazard because the latter was perceived as too costly or too inconvenient. The reaction to proposals to ban saccharin and to require the automobile seatbelt-ignition interlock, along with some other consumer protection measures, led Congress to back away from this approach. Agencies are now giving more serious attention to improving the information available to consumers, encouraging market competition as a means of upgrading the quality of products, and even undertaking educational efforts to change consumer behavior, as in the campaigns against cigarettes and alcohol.

The Panel considers the new approach to be sensible if and when consumers are in a position to evaluate the quality of a product and can avoid the harm if they wish. When consumers cannot make an informed decision freely, for example, because consumption is not voluntary, because consumers are too young to comprehend the risk, or because the information is too technical to be easily communicated and understood, the only methods that can be effective are more direct forms of government intervention. For example, pedestrians are not in a position to affect decisions about the braking system of an automobile that is purchased by someone else. In such circumstances, regulators will probably continue to prefer product safety standards.

Regulations to protect the consumer are likely to continue to be based on less intrusive techniques, particularly disclosure of information on the safety or utility of products. This approach is being used with prescription drugs. Regulators are requiring that inserts be provided that describe in straightforward language both the benefits and risks of a drug. Another quite successful disclosure program is standardized gasoline mileage ratings. These have been followed by similar requirements with respect to the energy efficiency of household appliances and home insulation.

Disclosure is attractive for many reasons. It preserves the independence of businesses and consumers and is inexpensive to implement and relatively easy to enforce. It also has limitations. Often it is impractical to collect the information that would be useful to consumers, or it is difficult to make it both accurate and comprehensible to a layman. Precisely what information to disclose is often difficult to ascertain; both too much and too little information can actually mislead a consumer. Finally, there is a question of when disclosure is necessary in order to ensure goods and services of high quality. In the past, regulators required disclosure because some consumers were known to be uninformed (for example, as to the ingredients in food products), not because any harm was befalling them.

Occupational Licensing

One of the most pervasive regulatory activities of state governments is the licensing of entry into a wide variety of occupations. Virtually all health professionals must be licensed: doctors, nurses, dentists, opticians, laboratory technicians, etc., as is true in many other professions requiring some degree of specialized training (law, engineering, education, hairstyling, architecture, contracting, and real estate).

Proponents of occupational licensing claim that it protects consumers from incompetent practitioners. They argue that the typical consumer has little or no basis for knowing whether a person has the necessary skills to provide a service safely and effectively. Government is needed to control entry and does so by establishing educational requirements, proficiency examinations, and standards of conduct without which a person cannot be licensed.

The principal argument against occupational licensing is that it is anti-competitive. Opponents contend that education, examination, and conduct requirements, while having little to do with effective performance, act as a barrier to people who want to enter an occupation. Further, many licensed professions have used entry requirements to establish standards of conduct that often serve to restrict competition still further, for example, by prohibiting advertising or solicitation of clients from competitors.

Opponents also argue that occupational licensing does not really protect consumers. There is usually no assurance that licensees will update their skills and knowledge. Moreover, many organizations such as labor unions can provide lists of qualified people to their employees or members.

Recent research indicates that state occupational regulation (e.g., licensing, advertising restrictions, impediments to interstate mobility of professionals) may have little positive effect on the quality of services but does encourage significantly higher prices. One study found that,

while no evidence suggested inferior dental care in states whose licensing boards had entered into reciprocity agreements with other states, prices in jurisdictions without reciprocity were higher.[1] Studies of the optometry profession have found higher prices in states that prohibit advertising than in states that allow it.[2]

Important changes are now being made in many occupational licensing policies. The legal profession no longer can use local bar associations as a means of enforcing anti-competitive rules on prices or advertising. As a result, fees for services associated with relatively simple legal matters such as divorces, wills, and deeds have been reduced. Local boards of realtors who have used the threat of denying access to the multiple listing service to enforce agreements on commission rates and other brokerage practices have been successfully challenged.

Other occupations, however, continue to strive for more stringent regulation. For example, the national association of professional nurses is attempting to require that all future registered nurses have a bachelor's degree. Historically, hospitals and community colleges with two- or three-year programs have produced a large percentage of nurses. While these programs require the same nursing training as do programs in college and universities, they do not include as many standard general studies courses. There is no evidence that graduates of hospital and community college programs are less qualified or have a poorer record in passing state examinations.

One effect of requiring an extra year or two of college would be to reduce the supply of nurses. Another would be to segment the profession. Supervisory positions and more demanding nursing tasks would no longer be available through promotion to nurses who perform best at entry level jobs. Instead, they would be filled on the basis of an employee's formal credentials. That requirement would also raise the salaries of nurses with proper credentials, in turn perhaps lessening the availability of services. Access of lower income groups to the better jobs would be reduced because they are less able to afford the additional year or two of education.

It is unlikely that occupational licensing will be eliminated. In some professions, however, it will probably come under increasingly close scrutiny. One alternative is to continue matching educational requirements with titles, but to reduce the extent to which only people holding that title can provide certain services. This would enable consumers and/or employers to choose either on the basis of licensing or on the basis of alternative criteria. An example now being debated is whether licensed midwives should be allowed to deliver babies without the supervision of a physician.

While most of these issues will arise primarily at the state level, in some cases they will be debated at the national level. Federal law, especially antitrust law as enforced by the Federal Trade Commission and the Department of Justice, is being used to limit self-regulation by certain professions such as law, medicine, and real estate. Further, as the federal share of payments for medical care approaches 50 percent and these costs keep escalating, government will look for reforms that will establish some control over medical costs. Occupational licensing practices that create shortages in some professions and that foster anti-competitive behavior will become logical targets of an increasingly cost-conscious government.

Nonprofit Organizations

Spokesmen for the nonprofit sector of the economy increasingly voice the same complaints about government regulation as business does. This is not entirely surprising, since many of the activities of a nonprofit organization are identical to those of a profit-making venture—hiring practices, for example. It would often undermine the purposes of a regulatory program to exclude nonprofit organizations from coverage. Moreover, in some areas such as hospital care and education, the distinction between nonprofit and profit-making activity has virtually disappeared.

Two kinds of regulation apply only to certain nonprofit organizations: (1) controls over fundraising activities; and (2) limitations on lobbying. Much of this regulation bears examination, and the 1980s will provide an opportunity to bring a measure of reason to the field.

Any effort to regulate the nonprofit sector must reflect the extraordinary diversity of the organizations within it. The primary or exclusive function of some groups such as the Ford Foundation or the Salvation Army is philanthropic. Others advocate a particular interest—the Consumers Union and the National Rifle Association. Still others, such as fraternities, are social organizations. Many institutions—churches, veterans' associations, and scouting groups among them—serve more than one purpose. There is a comparable variety of sizes and structures, ranging from small local groups to national organizations with hundreds of local chapters and millions of members.

This diversity makes dealing with the problems of the nonprofit sector exceedingly complex. Moreover, since many nonprofits are organized to promote religious activities or espouse controversial views, government regulation must be careful not to abridge constitutional rights such as the freedom of speech, assembly, and religion.

Regulation of nonprofit groups has arisen in part because of fraudulent practices. Scandals such as the abuses

by the Pallotine Fathers highlighted the problem of a charity using a disproportionately large share of donations for personal ends. In other cases, most of the money raised was spent on salaries and overhead, not programs. But the question remains whether the frequency of such abuse is sufficient to warrant government intervention beyond criminal sanctions, civil lawsuits, voluntary self-policing, and competition among similar groups for public support.

Different jurisdictions use a variety of regulatory techniques to discourage fraud by charitable groups. In 34 states and the District of Columbia, nonprofit organizations must register or obtain a license to engage in fundraising. Many states also require that organizations report annually on their financial activities, and some states and localities limit the percentage of donations that can be spent on fundraising. Finally, a number of states require disclosure of financial information to prospective donors.

The different regulatory requirements limit, in varying degrees, the independence of both the organizations and prospective contributors. For example, the percentage limitation on fundraising expenses may adversely affect both organizations and contributors by impairing the ability of nonprofits to make themselves known to the public.* New and controversial organizations are perhaps most seriously affected, since they have the greatest need for publicizing themselves and often the highest costs. A simple disclosure requirement might be equally effective and less intrusive.

The financial reporting requirements of different states are frequently in conflict, creating a substantial burden on small national advocacy groups. They argue forcefully that if regulation is needed, it can only be handled with consistency and efficiency at the federal level. Counter-arguments are that states are more familiar with local problems and local organizations.

The lobbying activities of some, but not all, nonprofit organizations are currently limited by tax laws. Although that restriction was eased somewhat in 1976, it remains a significant barrier to many groups who wish to influence legislation as part of their overall program.

There have also been recommendations for more regulation of lobbying activities in general; it would have particular effects on nonprofit groups. One proposal, which would require lobbyists to disclose the source of their income, would mean that nonprofits would have to identify donors. Such a disclosure requirement would dis-

* The Supreme Court decision in *Schaumberg v. Citizens for a Better Environment* held that a prohibition against door-to-door solicitation by a nonprofit group which spent less than 75 percent of its receipts on its charitable purpose was an unconstitutional interference with freedom of speech and association.

courage contributors who would be reluctant to become publicly associated with an unpopular cause. Moreover, for organizations with numerous small contributors, the reporting requirements could be quite burdensome. Another proposal, which would expand the requirements that lobbyists report their contacts with legislators and officials in the executive branch, could also be rather troublesome. The argument is often made that disclosure requirements have particularly onerous effects on nonprofits even though applied equally to profit-making organizations. Thus, both the decision to regulate and the choice of regulatory techniques should be carefully considered before action is taken.

In summary, the Panel anticipates a continuation of the trend toward policies that enable consumers to make better choices for themselves and away from direct regulation of products, services, and certain activities of nonprofit organizations. During the 1980s, more extensive use of disclosure requirements and continued antitrust attacks against occupational licensing should give consumers more choice and a better basis on which to choose.

Notes

1. Lawrence Shepard, "Licensing Restrictions and the Cost of Dental Care," *Journal of Law and Economics,* Vol. XXI (April 1978): 187-201.
2. Lee Benham, "The Effect of Advertising on the Price of Eyeglasses," *Journal of Law and Economics,* Vol. XV (October 1972):337-352; and Roger Feldman and James W. Begun, "The Effects of Advertising—Lessons from Optometry," *Journal of Human Resources,* Vol. XIII Supplement (1978):247-261.

Chapter 10

Discrimination, Workers' Rights, AND CORPORATE DECISIONMAKING

Three areas of government regulation, all based largely on a rationale of equity, are considered in this chapter. They are the prohibition of discrimination (including "affirmative action" undertaken to remedy past discrimination), protection of the rights of workers, and the regulation of corporate decisionmaking.

Discrimination

In the 1960s, black protest prompted Congress to prohibit racial discrimination in housing, voting, public accommodations, employment, and other areas. The success of the civil rights movement encouraged other ethnic and social groups to seek similar protection. The result was a host of new laws, regulations, and court cases. Despite such activity, discrimination remains a serious problem. Public debate about the appropriate nature and scope of corrective government intervention will probably continue unabated in the 1980s. This section explores briefly the controversies likely to arise in this complicated field.

Racial and Ethnic Discrimination. Some racial and ethnic groups continue to face severe problems, some of which have actually worsened in the last decade. In 1976, for example, the median income of blacks, the largest racial minority in the United States, was only 63 percent of that for whites. In 1979, the unemployment rate for teenage black males was 31.5 percent, up from 25 percent in 1970, as compared to rates of 13.9 percent for their white counterparts in 1979 and 13.7 percent in 1970. In addition, black males live an average of six years less than whites, and black teenagers are more than twice as likely as whites to be more than two years behind in school.* The statistics for Hispanics and Indians are roughly comparable.

The continuing disparity between the prosperity of whites and that of other groups has many oft-cited causes.

* In some areas the gaps have narrowed somewhat. For example, in 1976, the percentage of black males completing college was approximately a third of the comparable age group of white males, up from 20 percent in 1960.

One frequent explanation is that the differences result from ongoing discrimination, as well as the continuing effects of past discrimination. This is the basis of calls for more government intervention, not only in the form of more vigorous enforcement of discrimination laws but also of compensatory (e.g. job training) programs.*

In the 1980s, the federal government will continue to be a bulwark against discrimination. The debate will focus on the nature of the criteria and tools which the government will use to maintain that posture.

Affirmative action will remain controversial. The Supreme Court has begun to identify the permissible scope and character of activity undertaken to redress previous wrongs. The Court's decisions, however, have offered only incomplete guidance. In *University of California v. Bakke,* the Court ruled that a university effort to fill a fixed number of its medical school places with "disadvantaged" students (who were, according to university records, all members of minority groups) was improper because a less racially specific means of integrating its student body was feasible and there had been no governmental finding of injury resulting from a violation of law. Yet a majority of the Court stated that a university may accord some consideration to race in its admissions decisions.

Although the *Bakke* decision implied the Court's discomfort with quotas, the Court later (in *United Steelworkers v. Weber*) approved a 50 percent minority set-aside in a training program that had been established through collective bargaining. The Court found that Title VII of the 1964 Civil Rights Act does not condemn all private, voluntary, race-conscious affirmative action plans.

Still later, in *Fullilove v. Klutznick,* the Court approved the "minority business enterprise" provision of the Public Works Employment Act of 1977, which required that at least 10 percent of federal funds granted for local public works projects must be used by the state or local grantee to procure services or supplies from minority-owned businesses. Remaining for decision are questions of whether public employers are as free under the Constitution as they are under Title VII to engage in affirmative action, whether eligibility for federal contracts may be limited by executive order to those willing to take race-conscious action without a finding of discrimination to "correct" underrepresentation of minorities in their work forces, and whether courts may order such action to remedy discrimination when the remedies are not confined to the victims of such discrimination.

* The report of the Panel on Government and the Advancement of Social Justice: Health, Education, Welfare, and Civil Rights discusses a variety of compensatory programs. This section addresses only regulatory issues.

Quotas will continue to be a focus of attention. A rigid quota could have certain administrative advantages since it not only provides an unambiguous statement of a preferred outcome, but may also imply that the decisionmaker ultimately need not be concerned with anything but the desired number. Even though affirmative action programs generally steer clear of such an absolutist approach, considerable philosophical and political argument rages over the general concept. Some believe that affirmative action, when pursued through quotas or mechanisms resembling them, constitutes "reverse discrimination." Many persons who favored the civil rights legislation of the 1960s oppose quotas on the grounds that they violate the spirit of that legislation by further dividing society along racial lines. Furthermore, some blacks who may have suffered no personal discrimination at the hands of their employer are promoted ahead of whites who have committed no discriminatory act. Some have also argued that affirmative action generates a profound insecurity among the very people it is intended to assist; unearned rewards are cheapened, thus damaging self-esteem. On the other hand, affirmative action's supporters counter with assertions that strong measures are required to overcome the pervasive effects of past discrimination and that arguments to the contrary spring from naive assumptions or economic interests. The debate will evolve as new regulations and court cases further define what is legally permitted.

One area likely to see considerable discussion and litigation is the question of "disparate impact." Criteria not obviously racial in nature (such as educational attainment or lack of an arrest record) have been repeatedly attacked under Title VII of the 1964 Civil Rights Act for their disproportionate negative effect on protected groups. In *Griggs v. Duke Power Company,* the Supreme Court found that "good intent or absence of discriminatory intent does not redeem employment procedures or testing mechanisms that operate as 'built-in headwinds' for minority groups and are unrelated to measuring job capability." Since that case was decided in 1971, a battle has raged over what criteria may be legitimately related to job capability. The problem becomes especially acute when it comes to determining whether tests are valid predictors of job success and whether they are culturally biased. A case-by-case analysis of these issues is likely to continue for some time.

Sex Discrimination. The outcome of regulatory issues relating to sex discrimination will of course be affected by whether the Equal Rights Amendment (ERA) becomes law. If it is adopted, there will probably be a substantial amount of litigation aimed at defining its scope, and the courts will bear the major burden of determining the limits

of regulatory conduct in this field. Some new state legislation may be needed to amend laws that are inconsistent with the ERA, but there will probably be little need for new federal laws. If the ERA should fail, however, the women's movement is likely to pursue its goals on all fronts—not only through the courts, but also in the legislatures and agencies.

Women have not achieved the same level of protection that statutes and judicial decisions currently provide to racial and ethnic minorities. The 1963 Equal Pay Act made it unlawful to pay employees of one sex at a rate different from that paid to the other sex for equal work on jobs requiring equal skill, effort, and responsibility and performed under similar working conditions in the same establishment. However, this act did not ban discrimination in other areas of employment (e.g. hiring and promotion). Title VII of the 1964 Civil Rights Act expanded the prohibition against sex discrimination in employment, but other titles of that act do not apply to sex discrimination. The Supreme Court has also treated sex discrimination differently for purposes of interpreting the 14th Amendment. While racial, religious, and ethnic classifications are regarded as "suspect" and require a "strict scrutiny" test to determine if there is a "compelling state interest," classification by sex (as well as other categories) was long regarded as less invidious and therefore subject only to a test of "reasonableness." Most recently, the Court enunciated, in *Craig v. Boren,* a middle-tier test, somewhere between "strict scrutiny" and "reasonableness," which held that "classifications by gender must serve important governmental objectives and must be substantially related to achievement of those objectives."

Several issues relating to sex discrimination will be hotly contested during the 1980s. The Equal Employment Opportunity Commission (EEOC) has concluded that sexual harassment in the workplace violates Title VII of the Civil Rights Act. Employers, however, have complained about the vagueness of the EEOC guidelines, and the courts will almost surely be drawn more deeply into the matter. The Supreme Court has yet to rule on this EEOC interpretation of Title VII.

Long-standing concerns relating to equal pay have blossomed into a new issue: "comparable worth." Proponents of this concept contend that employers should calculate the "actual worth" of all jobs and examine those with a high number of women (or minorities, although the argument is predominantly used in reference to female-dominated office jobs) to determine if these jobs have been underpaid because they have been filled largely by women. Comparable worth faces a number of implementation hurdles. The Civil Rights Act allows unequal pay under

certain specified conditions. Another problem is the sheer difficulty of assessing the "comparability" of different jobs. Any government intervention in this area is certain to be highly disputed.

Another likely area of new controversy involves the circumstances, if any, under which employers may hire only men for jobs that present different risks to women—for example, a job in which exposure to chemicals could interfere with fetal development. Society will have to decide whether to allow that practice or to require the employer to make the workplace safe for all people: men, women, and unborn children alike. Satisfactory resolution of this issue will involve careful consideration of society's sometimes conflicting interests in equal employment opportunities for women, health, and the most efficient use of capital and labor.

Age and Lifestyle Discrimination. During the 1980s, as the age distribution and living patterns of the population change, discrimination based on age and lifestyle appears likely to receive increased attention. In some cases this will lead to calls for new regulatory requirements. In others, the calls will be for new interpretations or more vigorous enforcement of existing laws.

Controversy over employment discrimination against the elderly is likely to grow. Economic conditions may induce the elderly to remain in or re-enter the workforce to supplement fixed incomes. On the other hand, the "baby boom generation"—people born between 1945 and 1960—will begin competing for mid- and upper-level management positions. That competition will lead to pressures on older employees to accept early retirement. In view of the fact that many younger candidates will be women and minorities, there is a potential for conflict between affirmative action programs and efforts to prevent age discrimination.

The Age Discrimination in Employment Act of 1967 prohibits employers from discriminating against employees, or applicants for employment, who are between 40 and 70 years of age, unless age is a "bona fide occupational qualification." There has been comparatively little litigation under this statute. Therefore, the application of some important provisions, such as the occupational qualification exception, remains fuzzy. During the 1980s courts and regulators will probably have to define the scope of these prohibitions more precisely.

Another form of "age" discrimination—exclusion of families with children from rental housing—is also increasing. Although no national surveys have been performed, several studies in large cities indicate that sizable portions of residential rental markets—from 50 to 70 percent—are unavailable or available only with restrictions to families

with children. This situation will only worsen with the increase in families from the baby boom generation whom the scarcity of reasonably priced housing will force into the rental market.

There are several possible regulatory responses to this kind of discrimination. The government can provide low-cost housing specifically for families with children who cannot afford the rent needed to obtain adequate housing in a competitive market. It can offer subsidies (as in the form of guaranteed loans or tax benefits) to private builders who construct such housing. Finally, it could prohibit discrimination against families with children.

The latter regulatory approach is fraught with the same kinds of enforcement problems as arise in racial and sex discrimination. The first two approaches present problems of how to determine the appropriate level of subsidy. Resolution of these questions will depend ultimately on whether the society accepts discrimination against families with children (reflecting legitimate concern about the impact of children on the tranquility of the neighborhood) or considers it to be a groundless prejudice against a relatively powerless but vitally important segment of society.

The Panel also notes that discrimination based on a particular lifestyle—homosexuality—may be the focus of highly charged debates. The gay rights movement first emerged during the 1970s, and the homosexual population, which is still subject to discrimination in jobs, housing, and other areas, may press for protective legislation. The moral issues raised by homosexuality will tend to color any discussion of whether sexual preference is a valid basis for refusing to hire someone or rent an apartment to him. The decision about whether to prohibit such discrimination will require society to consider the degree of equity it wants to accord its homosexual citizens. That decision may be affected by the possible repeal of criminal laws that prohibit consenting adults from engaging in private homosexual conduct.

Enforcement. Attempts to attack all forms of discrimination share a common problem: how best to utilize and enforce the law. One approach would be to amend the statutes to provide greater incentives for victims of discrimination to bring private lawsuits. For example, under employment discrimination laws, punitive damages or damages for emotional distress are not authorized, although courts have ruled that those remedies are available under other civil rights laws. These limitations, as well as the prevailing prohibition against recovery of attorney fees from federal agencies (except for employment discrimination), could be removed. Another approach is to appropriate larger budgets for the agencies that enforce these laws. Greater resources might allow agencies to expand their efforts

beyond "test" cases, class-action lawsuits, and the most glaring of violations to handle more routine complaints brought by individuals.

Another enforcement issue will be that of priorities. Which areas of discriminatory conduct should be the target of more vigorous enforcement efforts? Will increased agency resources or greater incentives for private lawsuits really assure that the most serious instances of discrimination are given the highest attention? How can government minimize the possibility that such changes will encourage unsubstantiated or insignificant complaints? These and similar questions should be addressed in designing any enforcement program.

Finally, enforcement should not be viewed as the only appropriate form of government action. Increased employment opportunities for protected groups also require action to promote job opportunities and to overcome educational and other disadvantages. Nonetheless, the adequacy of enforcement of anti-discrimination laws must be questioned in view of continuing disparities, for example, between the income, health, and education of minority groups and the majority white population.

Workers' Rights

Apart from developments in the area of job discrimination, several important changes in the relationship between employers and employees may well emerge in the 1980s. One would be a change in the nature of the bargaining relationship between unions and management. Labor organizations might well insist upon extending the scope of collective bargaining to matters that have not traditionally been thought of as relating to working conditions. A major union could, for example, seek representation on the board of directors in order to influence corporate policy in such matters as product design and environmental goals. The success of labor in this regard would hinge upon its power relative to management, its inclination to share in an expanding agenda of administrative duties, and the likelihood that key political institutions of the country (i.e., Congress, the National Labor Relations Board, and the courts) could be persuaded to ratify the desire of unions for an expanded role in corporate decisionmaking.

Labor has also complained that contract negotiations between employers and unions need to be regulated more stringently to insure that "bad faith" bargaining does not confer an unjust advantage or undeserved rewards on management. For example, the defeated 1978 Labor Law Reform legislation would have, among other provisions, compelled a company, after a finding of bad faith bargaining on an initial contract, to compensate affected employees (according to an objective formula) for lost wages and benefits.

The "good faith" criterion has also become part of an emergent debate surrounding the problem of firing. Laws currently forbid discharging a worker on account of race, sex, age, and other specified grounds. The labor law reform legislation would require the National Labor Relations Board to seek preliminary injunctions in cases where an employee is unlawfully discharged during a union's organizing efforts or prior to negotiation of a first contract. The same bill also provides that back pay be awarded in such cases. Others have recently proposed even broader protection in this area—a worker could be discharged only for good cause—e.g., incompetence or dishonesty—even when no specific contractual protection existed.

There also remains the much-publicized question of how to deal with people who reveal secret, and purportedly illegal, corporate activity (whistle-blowing). One delicate problem is the extent to which the employee is to be held responsible for his actions. What happens if the whistle-blower's claim is erroneous? Presumably such factors as the amount of damage wrought by the charge and the intent of the employee should be balanced against society's real needs for ferreting out illegal conduct, which requires that employees not be unduly discouraged from reporting possibly illegal activity.

Pension matters will continue to occupy an important place in the discussion of worker's rights. There will be considerable debate about the conditions under which workers (or their families) are entitled to benefits. Questions will include the period of vesting and the rights of divorced or surviving spouses. Other suggested changes include eliminating pension reductions because of Social Security and guaranteeing pension credit for every year worked. One of the most interesting proposals is that the creation of Individual Retirement Accounts (IRA) be encouraged. Under this system, each employee (and his employer) would make tax-deductible contributions to his own tax-exempt pension plan that would be his alone, rather than to a group plan. The President's Commission on Pension Policy is currently studying these and related questions with an eye to enhancing both the equity and flexibility of the present pension system.

Since pension funds own a tremendous percentage of the stock issued by public corporations, an issue for the 1980s will be who exercises the shareholders' right to vote on corporate decisions such as membership on the board of directors. Currently, most administrators of pension funds do not actively exercise this right but generally follow management. In the 1980s, however, fund beneficiaries may demand that stockholder voting rights either be used more aggressively by fund administrators or be passed through to the beneficiaries. The latter arrangement would

place considerable power in the hands of a group with a strong incentive to be attentive to corporate behavior.

A closely-related issue is the extent to which pension fund investment and stockholder voting rights may be used to serve interests of beneficiaries beyond the maximization of the assets of the fund. The New York teachers' pension fund, for example, purchased New York City bonds (a questionable investment) in order to assure that the city would have adequate revenues to pay teachers during the next school year (a vital concern of the union which established the fund, but not of the already retired beneficiaries). To date, this kind of issue has not been common, but difficult economic conditions could make them more prominent and might lead to closer regulatory oversight of investment decisions.

Corporate Decision-making

In the past decade the argument has been advanced that America's largest corporations have become so powerful that they should be treated more like governments than private entities. Citing an alleged failure of state chartering, the increase in corporate crime, and the domination of corporate affairs by relatively homogeneous and unaccountable executive elites, some have begun to push for thoroughgoing reform of corporate governance.

Proponents of corporate change suggest that in the future a majority of the board of directors of large corporations should be "independent"—that is, not employees of the company, close relatives of an officer of the company, recent recipients of a fee from the company, or employees of any investment or commercial banking firm or any other substantial supplier or customer of the corporation. Another proposal would require that a board member assume special responsibility for specific areas such as consumer and environmental protection, community relations, and shareholder rights. Greater corporate disclosure, a ban on interlocking directorates, and an increase in shareholder power have also been proposed.

These far-reaching proposals are certain to encounter numerous objections. Opponents will argue that corporations need less regulation, not more, that a corporation's flexibility is thereby unduly (and perhaps mortally) threatened, and that the price of such corporate regulation will be decreased expertise at the top and a damaging drop in attention paid to tasks vital to the maintenance and enhancement of a company's production.

Recent developments have lessened the pressure for some of these proposals. In 1978, the Securities and Exchange Commission adopted rules requiring: (1) that directors disclose to the public certain personal and economic relationships with the management of a company;

(2) disclosure of the existence and functioning of audit, nominating, and compensation committees; (3) disclosure of the attendance of directors at board and committee meetings; and (4) public announcement of the resignations of directors. The following year the Commission adopted rules intended to provide shareholders greater opportunity to exercise their rights of ownership and to obtain information and advice about matters on which they vote. In addition, most major U.S. companies now have boards of directors on which the majority (and, in the case of the audit and nominating committees, all members) are independent.

Another issue that will warrant discussion during the 1980s is what government controls, if any, to impose on a company's "right to go out of business" or, more generally, to close a particular operation. Not only will corporations move their investments from failing or marginal ventures to more profitable activities, but it is possible that during the next 10 years a few, or even several, major corporations will approach financial collapse. The closing of a business, whether it is a Fortune 500 corporation like Chrysler or a factory which is the principal employer in a small town, can cause major disruptions. Government will be asked to intervene in various ways to lessen the adverse effects.

One response would be to require a company which is a substantial local employer to provide some minimum notice to the community before it is to close. The community would then have time to investigate such alternatives as attracting new businesses, finding a buyer for the concern, or perhaps converting the business to community or employee ownership. Another proposal is for government to soften the impact by providing enhanced benefits or retraining and relocation assistance for the unemployed workers, such as the "People to Jobs" program proposed in the report of the Panel on Policies and Prospects for Metropolitan and Nonmetropolitan America in the Eighties. A third is for government to subsidize—for example, by guaranteed loans—the continued operation of the company by either present management or by its employees.

Any sort of government intervention in this area must not be undertaken lightly. It could constitute an economically disastrous policy of protecting outmoded plants and industries at the very time that a consensus is building that government should promote, not retard, economic growth and innovation. If the firm is going out of business in order to reallocate corporate resources to a more profitable area, any type of government intervention—whether regulatory or not—can produce economic inefficiency. Consequently, government policy should focus on temporary, one-shot

measures to ease the transition to a more productive industrial structure, rather than permanent, institutionalized protections and subsidies for inefficient operations.

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Chapter 11

GOVERNMENT **Control** OVER **Individual Conduct**

Government control of individual decisions concerning personal conduct is not ordinarily an issue in debates about regulation. However, for a number of reasons, the Panel felt it desirable to include this topic in its report.

First, in many areas, regulation makes no distinction between the conduct of individuals and businesses. For example, it is just as unlawful for a homeowner to pollute a stream as it is for an industrialist. Likewise, it is just as improper for an individual to violate zoning restrictions as it is for a business to erect a factory in an area reserved exclusively for small retail establishments.

Second, although the initial, direct impact of much regulation is on businesses, the indirect and ultimate effect is on individuals. Perhaps the clearest example is occupational licensing, a type of regulation that is supposed to ensure that professionals provide competent service to consumers. This form of regulation prohibits unlicensed individuals from providing a regulated service, no matter how qualified the provider or how informed the consumer. Thus, occupational licensing usually leaves even the best informed consumer with the unhappy choice of paying higher fees to a licensed provider or foregoing the service entirely.

Third, all the analytical questions discussed in this report—who should regulate? what tool should be used? how to approach uncertainty?—arise in the regulation of individual behavior. In particular, a comparative examination of the regulatory methods employed in both fields could prove useful. For example, the principal technique used in many statutes regulating individual conduct is outright prohibition of certain activities, even though that approach would create enormous opposition if applied to business.

Finally, the everyday concerns of many Americans are being omitted from the conventional debates over deregulation and regulatory reform. For these Americans, the issue of government control in the 1980s will involve personal (and largely moral) matters such as laws that make

criminals of those who engage in private homosexual activities, who possess small amounts of marijuana for personal use, or who gamble. There are also persons wishing to restore school prayer or outlaw abortions. The Panel thinks that to neglect these issues, around which so much controversy has erupted, would be to exclude issues that many citizens feel are among the most important topics for the 1980s.

The role of the court system (the Supreme Court in particular) has been, and will continue to be, crucial to the resolution of these matters. The era of the Warren Court is generally regarded as the high point of judicial protection of individual rights. That period is either praised or condemned, depending upon how one views the Court's decisions. While the Supreme Court under Chief Justice Warren Burger is generally considered to be more conservative in its approach to individual rights, in 1973 it produced perhaps the single most controversial decision affirming the rights of individuals against the state—ruling that a woman has a constitutional right to obtain an abortion, at least during the first trimester of pregnancy. The Court, regardless of its composition, will probably continue to play a major role in safeguarding individual rights against further legislative encroachment, but it is not likely to overturn many of the controls contained in existing law. Thus, those who seek change in the present system of regulation of individual conduct must look primarily to the legislatures.

As with the regulation of business entities, the Panel has not attempted to resolve the issues that will be on the agenda for the 1980s. Rather, it has sought to identify the range of governmental restrictions, to point out their common traits, to discern some lessons from the past, and to suggest some ways for government to consider these issues in the future.

Regulation of Individual Choice Today

Among those restrictions currently directed primarily at individuals are some that have a long history and are unlikely to be challenged. Nevertheless, their rationales need to be understood to appreciate the challenges in other areas. Society is accustomed, for example, to accept compulsory payments for police, highway, sanitation, and fire departments. There are few advocates of, for example, sole reliance on voluntary fire departments and casualty insurance to protect the individual homeowner. In most cases, the reason for accepting interference in the "right to have your house burn down" is a recognition that the greater good of society requires a pooling of interests and that it is inefficient and unwise to allow anyone to "opt out," either to get a free ride or to suffer the consequences of unlikely but serious occurrences. Similarly, in areas such as national

defense, there is no way of assessing on an individual basis a fair share of a citizen's use.

There are other forms of constraint on individual choice that are, by and large, accepted. There is no significant political (and scant philosophical) support for the idea that parents, as part of their right to raise their children as they see fit, should be allowed to keep their young ones away from all forms of schooling. The obvious rationale for this rule is the great importance of education to the child and to society.

In contrast to these relatively non-controversial, often unexamined "interferences" in private decisionmaking are a number of other laws that will face challenge in the 1980s. Among the most controversial are those relating to gambling; the possession of marijuana for personal use; sexual morality (including prostitution statutes and prohibitions on private homosexual activity); and motorcycle helmet and automobile seatbelt laws. Many of these laws initially affect business entities. Ultimately, however, they aim at denying the public the right to engage in some behavior. Anti-usury laws, another part of the debate, date back thousands of years. Their modern-day counterparts limit the amount of interest that commercial banks, savings-and-loan associations, and credit unions are allowed to pay on deposits. These laws directly affect commercial entities, but indirectly and ultimately deny an individual credit or reduce the interest he can be paid.

Less frequently considered to be interference with the rights of individuals, but arguably a form of it, is social security. The original debate was whether the government should require individuals to save when they failed to do so on their own. Today, it is generally recognized that social security is partially an income redistribution plan, not simply a mandatory savings device. As a result, the debate has shifted from notions of free choice and the right to spend oneself into bankruptcy as old age approaches and income opportunities are fewer to considerations of equity.

All these matters involve the question of whether to make conduct that is now prohibited lawful. There is, however, at least one attempt to go in the opposite direction—on the issue of cigarettes. The Surgeon General's report of 1979, for example, indicates that thousands of Americans lose their lives each year as a result of smoking. Citing these data, some have argued that cigarettes should be banned entirely.

These different kinds of governmental interventions in private actions have a number of common characteristics. None of the laws is aimed at minors alone or at those unable to make intelligent decisions. All involve more than mandatory disclosure, and in most cases they reject any means of control less restrictive than outright prohibition

backed by criminal sanctions. Many critics claim that these laws reflect a paternalistic attitude on the part of government: individuals are not capable of perceiving and acting on what is in their own best interest. Furthermore, many of these laws, such as those dealing with prostitution, gambling, and marijuana, are plagued by substantial enforcement problems, since the alleged victims not only resist protection, but often affirmatively seek to do that which is forbidden. Each of the issues generates intense debate, and many threaten to create serious political problems by spawning single-issue candidates and movements. Finally, and perhaps most important, these laws ban activities that many believe do no harm to third parties. Stated another way, these laws are generally designed to protect people against their own worst instincts.

As with other areas of regulation, there is also the problem of uncertainty. Is marijuana harmful or not? Is the prostitute being exploited? Is there really no harm to third parties in gambling? Would deregulation of victimless crimes deprive organized crime of its financial empire? Clearly, the answers are ambiguous and, in some cases, unknowable.

Lessons from the Past

In considering this area of regulation, the Panel believes that the experience of Prohibition is instructive. Prohibition showed that it is extremely difficult to legislate morality, even when most people recognized that the prohibited conduct could have serious physical effects on the person engaging in it. Even a constitutional amendment prohibiting the sale of alcoholic beverages did not eliminate drinking. Rather, the activity was driven underground where it was taken over by criminal elements. As a result, bootlegging became the cornerstone of organized crime, which today controls current prohibited activities—gambling, drugs, pornography, and prostitution.

The shift from legitimate to unlawful channels of distribution can, as Prohibition illustrated, create significant law enforcement problems. Effective enforcement not only required very large amounts of resources, but caused government to engage in conduct that involved invasions of privacy which, regardless of their constitutionality, came dangerously close to intruding upon American society's most basic freedoms. Prohibition also suggested that, where what are known as "victimless crimes" are involved, and where there are large financial gains to be reaped from supplying illegal goods and services, the incidence of bribery and corruption increases significantly.

The post-Prohibition era has provided another important lesson: government has a greater range of choices than the outright ban or complete freedom. States now license

(some own outright) all liquor stores within their borders. There are also rules limiting the number and location of package stores and bars, and sales are often restricted to certain times of the day or week. In addition, states tax alcoholic beverages heavily to discourage their use and, in the process, raise substantial revenues. Finally, every jurisdiction forbids the sale of liquor to minors under any circumstances.

In some areas of government intervention in private decisions, there has already been substantial deregulation. Examples are the legalization of abortion, the introduction of some forms of legalized gambling, such as horse racing or lotteries, and in some jurisdictions the decriminalization of the possession of small amounts of marijuana.

Another example of "deregulation," although it has rarely been referred to that way, is the sweeping change in divorce laws. Until relatively recently, most states allowed married couples to be divorced in only a few circumstances. Adultery, desertion, and physical abuse were the most common, though by no means universal, grounds. Only Nevada would grant a divorce when the parties simply no longer wished to be married. Many couples were faced with two choices: perjury or a trip to Nevada (or perhaps Mexico or the Dominican Republic for those more adventurous or less patient). These alternatives had distasteful aspects. Aside from questions of criminality, many individuals were unwilling to lie, although many were prepared to shade the truth. Even Nevada required some willingness to be less than candid. As does every other state, it required an assertion of residence, although no questions were asked of those who had lived there for at least 6 weeks. In addition, the cost of moving to and living in Reno was prohibitive for all but the most affluent.

Today, the nearly universal rule is that if a marriage is irretrievably broken, it is not the business of the state to keep it together. There are still barriers: lengthy residence requirements, legal documents, costs imposed by the system. And, of course, the state still maintains an interest in assuring that children are adequately taken care of. Nevertheless, although it is still more difficult to dissolve a marriage than to begin one, it is fair to say that there has been substantial deregulation in the divorce area. In short, state intervention has been largely eliminated from this essentially private matter.

Applying the Lessons of the Past

There is today little or no movement to return to the days of the 18th Amendment. Yet, surprisingly, the lessons of Prohibition have not been as widely applied to other areas as logic would suggest. The Panel concludes that in each case where regulation of individual decision is proposed, government should first examine the harm that is alleged to befall society and the individual and then evaluate the

likelihood that such consequences will occur. Where possible, society should try to resolve these questions on a consistent basis. Regulators should compare the kind of harm they are willing to tolerate in one area with that which is outlawed in another to see whether the pattern is sensible.

For example, in some states motorcyclists are not required to wear helmets, and yet the sale of pornography to adults is illegal. It would be useful for legislators to compare the harms to be avoided by regulation—both to individuals engaged in the activity and to society in general—in the two situations. Is the harm from pornography, both to the reader and others, greater than that resulting from non-use of motorcycle helmets? The answer depends in part on the impact of the activity on others, and thus it will be necessary to consider closely whether the claims about the harmful effects of the activity, and the benefits to be gained by regulating it, are valid. For instance, does gambling disrupt family life, or does that claim mask personal or moral prejudices? Even if gambling does create social costs, can the law be effective given that the compulsive gambler usually is not deterred by legal prohibitions?

Another pertinent question is how much will regulation restrict an individual's freedom. Freedom of choice—the principle that individuals should be free to engage in whatever conduct they choose as long as it does not injure anyone else—is a fundamental tenet of this country. The notion of free choice is often brought forth by those favoring the deregulation of business, but it is too rarely voiced when government attempts to interfere with personal moral choices. If anything, there should be greater restraint in regulating personal conduct than activities having direct effects on third parties. In this context, denial of free choice often means that society has decided to protect its members not from one another, but from themselves.

Cost must also be considered. One might question, for example, the value of protecting citizens from receiving bad legal advice by prohibiting non-lawyers from doing certain work, if a citizen cannot afford to retain a lawyer and thus receives no assistance at all. If society is considering restricting certain activities to licensed persons, it must ask whether the public has a financially realistic opportunity to employ them. If not, it might be preferable to allow consumers to purchase the services of persons with less training, but an affordable fee. This has been done in medicine, where people with modest training perform many of the functions, such as routine health checkups, that formerly were provided solely by licensed professionals.

While there are strong cases for deregulation of some proscribed activities, at the same time other kinds of regulation are clearly sensible. For instance, it is not acceptable to allow older Americans to die because they did not save

enough money. For that reason, if no other, Social Security will never be written off the books. Likewise, while few or no adverse effects would result from removal of most occupational licensing requirements, it is appropriate to retain those affecting highly skilled activities. Thus, there is no serious argument that everyone should be free to perform open heart surgery or fly a commercial airliner. If a decision is made to regulate or to retain an existing control, then it is very important to choose carefully the method of intervention. Restricting the time or place of an activity, or the age at which it is permissible, may be preferable to an outright prohibition. In particular, laws dictating sexual morality should be examined to see whether a more limited approach would be more in keeping with the right of free choice and would reduce enforcement costs.

The Panel therefore urges that in deciding these questions, legislative bodies carefully consider the scope and likelihood of alleged harms to the individual and to others. Legislatures must also bring into the balance the element of individual choice and the unjust imposition of unaffordable costs, either on the individual being protected or on society as a whole in enforcing the law. The Panel recognizes that this balance is not mechanical but involves judgments that are *political* in the highest sense of the word. The factors upon which such judgments ultimately rest are not always quantifiable, but they are identifiable. Their respective weights are properly the subject of rational, focused debate. In the end, these are decisions to be made by society, either through its elected representatives or by public referenda.

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